

Week  
**37**

# Stories To Read From FNArena

## Friday, 13 September 2019

FNArena  
Financial News, Data &  
Analysis

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## Contents

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### Asia

**1** [Five Feet High And Risin'](#)

### Australia

**2** [Negatives Mount For CYBG, Dividends Unlikely.](#)

**3** [Brokers Remain Hopeful Of A Retail Pick Up](#)

**4** [A-REITs Subdued Despite Low Bond Yields](#)

**5** [Diversity Paramount For Synlait Milk](#)

### Commodities

**6** [Material Matters: Gold, Coal, Oil & Copper](#)

### ESG Focus

**7** [ESG Focus: The Rise Of The Vegan](#)

### Feature Stories

**8** [Australian Banks: Navigating The Mine Field](#)

### FYI

**9** [Weekly Ratings, Targets, Forecast Changes - 09-09-19](#)

**10** [Uranium Week: Positive Outlook](#)

**11** [The Short Report - 12 Sep 2019](#)

**12** [The Wrap: Economy, Utilities & Building](#)

### Treasure Chest

**13** [Treasure Chest: Index Unrivalled](#)

**14** [Treasure Chest: AGL Mired In Uncertainty.](#)

### Weekly Analysis

**15** [The Right Lessons To Learn](#)

**16** [Rudi's View: Rotation Anxiety & Conviction Buys](#)

## Five Feet High And Risin'

By Richard (Rick) Mills Ahead of the Herd

As a general rule, the most successful man in life is the man who has the best information.

Five Feet High And Rising

How high's the water mama? Five feet high and risin' Hows high's the water papa? Five feet high and risin'

Well, the rails are washed out north of town We gotta head for higher ground We can't come back till the water comes down, Five feet high and risin'

Johnny Cash, "Five Feet High and Rising"

US stock markets last week were like a teenager forced back to school after a summer of fast cars and girls - insolent and bad-tempered. Snapping a three-day winning streak, the Dow and the S&P 500 both fell after US and Chinese tariffs took effect over the long weekend. The sell-off was also influenced by weak US manufacturing data, and more worries over the UK crashing out of the European Union, after the governing Conservative Party lost its majority in the House of Commons due to a Tory member crossing the floor to the Liberal Democrats.

The US manufacturing index for August was just 49.1, marking the first time in three years that America's manufacturing sector shrank, stoking fears that the slowdown in Europe - Germany is already in recession - has crossed the Atlantic.

The benchmark 10-year Treasury yield slid to 1.47%, from Friday's close of 1.50%. Two weeks ago the 2-year Treasury note was higher than the 10-year, a worrying signal that investors are less willing to risk their money on a long-term debt instrument. Known as a yield curve inversion, this phenomenon has been a near-perfect recession indicator for the past 60-odd years.

The last two Treasury auctions saw the 10-year and the 2-year offering the same rate of interest, not exactly a vote of confidence.

At least US Treasury yields are still holding above zero percent. At last count the amount of global sovereign debt floating around at negative yields was valued at close to \$17 trillion.

Putting it all together, the trade war is showing no signs of a cease fire, we have record amounts of negative-yielding sovereign debt, key yield curves inverting for the first time since the Great Recession, manufacturing activity has slackened across the Group of Seven countries, and the US corporate sector is eyeing a horrible third quarter.

According to Refinitiv, a financial data provider, Q3 profit growth is expected to drop to -1.9%, a hard fall from the 12.1% forecast a year ago.

A reading of Zero Hedge finds many more signs of economic gloom and doom. I cherry-picked 13:

#3 Yield curve inversions have preceded every single U.S. recession since the 1950s, and the fact that it has happened again is one of the big reasons why Wall Street is freaking out so much lately.

#4 We just witnessed the largest decline in U.S. consumer sentiment in 7 years.

#5 Mortgage defaults are rising at the fastest pace that we have seen since the last financial crisis.

#6 Sales of luxury homes valued at \$1.5 million or higher were down five percent during the second quarter of 2019.

#7 The U.S. manufacturing sector has contracted for the very first time since September 2009.

#8 The Cass Freight Index has been falling for a number of months. According to CNBC, it fell "5.9% in July, following a 5.3% decline in June and a 6% drop in May."

#9 Gross private domestic investment in the United States was down 5.5 percent during the second quarter of 2019.

#19 Global trade fell 1.4 percent in June from a year earlier, and that was the biggest drop that we have seen since the last recession.

#12 When it looks like an economic crisis is coming, investors often flock to precious metals. So it is very interesting to note that the price of gold is up more than 20 percent since May.

#21 According to CNBC, the S&P 500 “just sent a screaming sell signal” to U.S. investors.

#23 Corporate insiders are dumping stocks at a pace that we haven’t seen in more than a decade.

#24 Apple CEO Tim Cook has been dumping millions of dollars worth of Apple stock.

#25 Instead of pumping his company’s funds into the stock market, Warren Buffett has decided to hoard 122 billion dollars in cash. This appears to be a clear indication that he believes that a crisis is coming.

Yet equity investors appear unfazed. Despite global chaos blamed in large part on the Trump administration’s trade spat with China, 2019 is shaping up to be one of the best years for stocks since the financial crisis. Year to date, the S&P 500 index of companies is up 15.7%, the Dow has barreled along at 11.8%, and the technology-heavy Nasdaq has gained an impressive 18.1%.

Also out of kilter is the gold price which usually moves down when stocks are up (gold and the US dollar also have an inverse relationship). Yet instead of plummeting to earth, bullion’s one-year chart resembles a StairMaster, from a lowly \$1,200.30 on the last day of August, 2018, to [last] Tuesday’s \$1,548.12, as of 6:12 pm in New York.

Among the factors fueling gold’s run are negative real interest rates. Gold is favored among investors when long-term Treasury yields offer negative rates of return ie. when the yield minus the rate of inflation, currently 1.8%, falls below zero. Why buy a negative-yielding bond when you can catch the wind in the sails of a gold price knifing through the water at 20% year to date?

So what’s going on? Why is gold doing so well when stocks are heading higher, and how come stock markets haven’t been smacked harder by all these global headwinds?

The answer lies in stock buybacks and insider selling. Allow me to explain.

#### Stock buybacks

When Ronald Reagan became president in 1981, he appointed John Shad to head the Securities and Exchange Commission - the body that polices US stock markets. Shad’s appointment was the first time in 50 years that a financial executive headed up the SEC.

The SEC’s role since the stock market crash of 1929 was to regulate stock markets and especially to prevent another Great Depression from happening. The 1934 Securities Act didn’t ban stock buybacks but it barred companies from doing anything to manipulate their stock prices. Companies therefore stayed away from the practice of buying their own stock, fearing it would put the company on the SEC’s radar.

Under Shad’s leadership the SEC in 1982 adopted rule 10b-18, which allowed stock buybacks as long as certain guidelines were adhered to, such as not purchasing more than 25% of its average trading volumes in a single day.

Vox quotes William Lazonick, an economics professor at the University of Massachusetts, who said Shad’s appointment to the SEC and the passing of rule 10b-18 brought about a major shift in the agency:

“Everything they did from that point forward ... was turning the SEC from a regulator of the stock market to a promoter of the stock market,” he said.

US lawmakers on both sides of the aisle have spoken against stock buybacks.

So what are stock buybacks and why are they controversial?

Buybacks have been a popular tool for management to stuff cash back into the company, indirectly, by reducing the share float (outstanding shares). Purchasing company stock generally inflates the share price and boosts earnings per share - a key metric on which CEO bonuses are calculated.

After the SEC changed the rules to allow buybacks, hundreds of companies starting using them. In 1997 buybacks surpassed dividends as the main way companies redistribute funds to investors.

Are share buybacks good or bad for shareholders? The answer is, in my opinion, cut and dried - the few positives do not outweigh the many negatives.

On the positive side of the ledger, reducing a company's outstanding shares makes each dollar of earnings more valuable on a per share basis, which is good for investors.

Another plus for shareholders: corporate executives seemingly know how much their company is worth so if they are buying back shares, it's a signal that the stock is undervalued - otherwise, why would they buy high?

Bloomberg states that buybacks can contribute to bull markets, noting that in some years, shares bought in buybacks outnumbered shares purchased by mutual funds by six to one. Really though, the most insightful thing to say about share buybacks is that they're good for management, not necessarily shareholders.

Why? Buybacks make it easier for executives to hit targets by reducing the number of shares. Management receives compensation - usually in the form of stock options - that is tied to the company's stock price. The higher the stock price the more they make cashing out their options. When a stock buyback occurs the short-term implications on the stock price are positive. If a company's stock is suffering from low earnings per share (EPS) and price earnings ratio (PE), buying back stock can give the company a temporary boost because these ratios are based on the number of outstanding shares. Earnings don't change but the EPS looks better because the firm has reduced the number of shares outstanding, so management meets goals for profit growth and earns bigger bonuses.

There are plenty of negatives to share buybacks, with the most obvious being that buying back shares means that executives are foregoing the opportunity to put that extra cash back into the business instead, which could potentially grow the company. Studies have linked increased spending on buybacks to decreased corporate investment - such as expansion plans, more hiring or raises. Buybacks have been used as a punching bag for Democrats in particular who argue that buybacks enrich companies and wealthy shareholders at the expense of workers, who miss out on companies spending their excess profits on hiring more employees or issuing raises.

Share buybacks are therefore thought to exacerbate inequality. A Gallup poll quoted by Vox shows only half of Americans own stocks, with the richest 10% owning 80% of all shares and the bottom 80% of income earners owning just 8%.

As for how share buybacks fit into the current financial paradigm, they have become exceedingly popular as companies look for ways to stash their extra cash brought about by pro-business tax legislation.

In December 2017 the Trump administration passed the Tax Cuts and Jobs Act. The legislation slashed the corporate tax rate from 35% to 21% and the top individual tax rate shrunk to 37%.

But the most important change concerned the repatriation of profits that US corporations were holding overseas. Under the act, companies were incentivized to bring their overseas profits to the United States, where they would be taxed at a one-time rate of 15.5%, which is lower than the regular corporate tax rate of 21%. Previously, companies would "defer" (really, avoid) US tax on profits held in low-tax jurisdictions like Switzerland and Ireland, until they brought their profits into the US, where they would be taxed at 35%.

In 2018, US multinationals took full advantage of the "tax holiday", sending home over half a trillion dollars held overseas, to be taxed at the lower rate.

Suddenly these companies found themselves flush with cash, and they needed to find a way to spend it. The options are typically to: Plough funds back into the company via capital expenditures like new buildings, products or equipment; distribute the money back to shareholders in the form of dividends; share buybacks which don't go directly to shareholders, but reduce the number of outstanding shares, thereby making the share float less diluted.

In 2018 US companies set a record \$1.1 trillion in stock buybacks. Apple is the biggest re-purchaser, having poured a quarter trillion dollars into buying its own stock over the last decade, according to CNBC.

Since 2012, Apple's buyback program cut its outstanding shares by one quarter, doubled its earnings per share, and ended up with a 150% increase in its share price.

Other FANG stocks have jumped on the buyback train.

Since Alphabet launched its buyback program in 2015, Google's parent company has repurchased \$17 billion worth of stock, thereby helping to reduce its total share count and, like Apple, double its per-share earnings. Over the past four years, Alphabet's stock has run up 123%.

The data shows share repurchases have increased at a higher pace than the more direct means of rewarding loyal shareholders - dividends. As shown in the graph below, while cash dividends have risen gradually since 1988, buybacks are a lot more volatile. From the Indexology blog: "The amount of buybacks jumped significantly right before the 2008 global financial crisis and dropped drastically in 2009. Since 2010, the amount of buybacks has continuously grown and exceeded the amount of dividend distributions."

There is clearly a strong connection between repatriation, stock buybacks, and higher-than-normal corporate earnings. Is it any coincidence that half a trillion dollars' worth of overseas profits were brought home in 2018, during which time the United States saw the most share buybacks in history, along with sky-high corporate earnings (data firm Refinitiv estimates profit growth among S&P 500 companies at 23% in 2018) and a booming stock market? I don't think so.

Even though repatriation has run its course, buybacks are still popular on Wall Street. In the first quarter of 2019, S&P 500 share repurchases totaled a record \$223 billion. And even though the second quarter saw a decrease, it was still the second highest quarter, ever, for buybacks, which rose for four consecutive quarters prior to Q2.

+ Insider selling

If all these top companies are buying their own shares, boosting their earnings per share, padding their bottom lines and inflating their stock prices, their leadership must be brimming with confidence that all is well with the economy, right?

In fact, nothing could be further from the truth. A little research shows that executives have actually been dumping their own company's stock, capitalizing on the price bump resulting from torrid buyback programs.

A recent report from TrimTabs shows many more CEOs are selling shares. CNN Business reports corporate insiders sold an average \$600 million of stock per day in August - making it the fifth month in a row that insider selling topped \$10 billion. The last time that happened was in 2006-07. Among the stock dumpers are top executives from Salesforce, Visa and Home Depot.

Why would an executive sell his/her shares if they didn't see bad news on the horizon? The answer is, they wouldn't. While some try to defend the practice as "portfolio diversification" or some malarkey, the reality is, no-one purposefully dumps shares if they have faith in the company and its stock price. The only reason to sell is to cash out. Here is SEC Commissioner Robert Jackson disparaging insider selling:

"When executives unload significant amounts of stock upon announcing a buyback, they often benefit from short-term price pops at the expense of long-term investors," he said in a letter quoted by CNN, adding that "insider selling on buybacks is associated with worse long-term performance." He added:

"CEOs don't sell valuable things cheaply. Executives are using buybacks as a way to cash out."

Vox notes that the recent trend of "activist investors" who buy large blocks of shares to get seats on a company's board, is another distasteful way for such investors to influence the direction of a company through buybacks.

The publication states that billion hedge fund manager Carl Icahn in 2013 convinced Apple to increase its stock buybacks in 2013, the same year he bought into the company. Three years later he sold his stock and made \$2 billion.

On August 29 and 30, for example, Facebook's CEO Mark Zuckerberg unloaded two lots of 125,600 shares each totaling about \$23 million.

= Rising gold price

The really interesting comparison is between share buybacks, insider selling and the gold price. Could it be that these corporate insiders, who really are "the smartest guys in the room" with knowledge nobody else has regarding the future of their companies, be selling because they see the big red sign flashing 'R' for recession? That the time to sell is now, before the next Trump tweet sends stock markets into a downward spiral, before all those yield-curve inversion chickens come home to roost? And that it's also a good time to be buying gold?

We think so, and we can prove it. The historical gold price chart below shows gold bumping along at around \$400 an ounce from the 1990s to 2002. The buybacks chart courtesy of Visual Capitalist reveals a similar chart pattern to gold except for a peak in 1999 and a decline from 2001-04. That makes sense, because tech companies in particular likely had the most excess cash to buy their own stock at the height of the bubble, in 2000, before it burst in 2001 causing a recession, indicated by the blue bars heading down until 2004.

The mining supercycle that started around 2000 is reflected in the gold price chart, with bullion on an upward trajectory for over a decade, peaking at around \$1,900/oz in September 2011. Stock buybacks also gather momentum during this period, peaking in 2007 just before the financial crisis, falling to under \$200 billion at the bottom of the recession in 2009, then heading back up to reach above \$1 trillion in 2018.

It's tougher to find a correlation between the gold price and insider stock sales but we do know that stock repurchases correspond closely to insider selling. Research by the SEC, in a team led by Commissioner Jackson, showed that executives often use buybacks to cash out their holdings of company stock. Vox reports the 2017 study looking at 385 buybacks since 2017 found that in half, at least one executive sold shares in the month after the

buyback announcement. Twice as many companies had insiders selling stock within eight days after the announcement, as they would on a normal trading day.

An increase in executive stock selling also closely matches the bump in the number of share repurchases since the above-mentioned repatriation of profits that came with the \$1.5 trillion in tax breaks passed by the Trump administration in 2017, according to Politico.

## Conclusion

The continued stock market bull we are seeing playing out week after week has lulled many an investor into a false sense of security. Returning to the Zero Hedge article mentioned at the top, we know there are many recessionary signals that we as smart commodity-focused investors need to pay attention to.

We also know that a big surge in stock buybacks occurred in 2007, a year before the Great Recession. Looking at Visual Capitalist's historical buyback chart is instructive because we see the same pattern emerging, of a dramatic rise in buybacks, in line with high corporate profits amid the stock market bull. In 2009 those buybacks fell off a cliff, as companies saw earnings drop while global growth stagnated. Are we riding the rapids towards another waterfall?

Meanwhile company insiders are using the opportunity of buyback programs to cash out their holdings. Investors are challenged as to when is the best time to buy and sell their stocks. Timing the market is hard, but a major red flag should be when a key insider dumps their shares. Ignore these share sales at your own peril. The current insider share selloff is the best indication that I've seen to get out of equities (at worst you'll be taking profits too soon) and, in my opinion, into the protection offered by the best safe haven for these troubling times: gold and junior gold stocks.

How high's the water, papa? Five feet high and risin'

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Richard is the owner of [Aheadoftheherd.com](http://Aheadoftheherd.com) and invests in the junior resource/bio-tech sectors. His articles have been published on over 400 websites, including:

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FNArena is proud about its track record and past achievements: Ten Years On

## Negatives Mount For CYBG, Dividends Unlikely

Negative factors continue to pile up for UK bank CYBG, amid unprecedented provisions for potential claimants in its FY19 accounts. Brokers rush to remove dividends from forecasts.

-Quantum of increase in complaints in August takes brokers by surprise -Current share price implies a buying opportunity -Yet many uncertainties remain including Brexit

By Eva Brocklehurst

The outlook for CYBG plc ((CYB)) has turned incrementally negative after the UK bank announced unprecedented claims provisions for payment protection insurance (PPI) in August.

CYBG has announced an additional GBP300-450m in provisions for these claims, which will impact statutory, not underlying, profit. CYBG has found it difficult to fully estimate the costs, as the main issue is the conversion rate for complaints that are subsequently upheld. The bank assumes a 5-12% conversion range for upheld complaints.

Hence, the final financial outcome could be much lower, or higher, but this is unknown. The bank expects to take several months to assess the quality of the information requests and the related financial impact and should be in a position to provide a more accurate estimate of costs at the FY19 results on November 28.

A ramp-up in complaints was expected but the quantum of the increase surprised Macquarie, which compares CYBG's top-up provision with Royal Bank of Scotland's announcement of a GBP600-900m increase, on a balance sheet that is nine times larger than CYBG.

Morgans calculates the top end of the provision range equates to a hit of 30p per share on an after-tax basis and, for every 5% of information requests that convert to an upheld complaint, the provision will increase by GBP100m. Morgans does not envisage a need for equity capital to be raised but remains mindful of the risk of hits to the CET1 ratio as well, from group legal action on fixed-rate tailored business loans.

The broker acknowledges some investors may take a view that the current share price provides an encouraging discount but highlights that a disorderly Brexit could have an impact on credit growth and asset quality. There is also the risk of further top ups to PPI provisions.

### Dividend Impact Expected

Citi suspects the market is taking a worst-case scenario and these last-minute requests could be lower quality, and subsequently dismissed. Along with margin pressures and Brexit concerns the provisions have weighed on the stock, but the broker believes the current share price offers an attractive entry point, maintaining a Buy rating and reducing the target to GBP1.80.

The dividend is likely to be reduced or even cancelled but a capital raising is unlikely. A capital raising would be highly dilutive, the broker suggests, and slow down growth.

Macquarie considers CYBG's capital is vulnerable, and its position is no longer superior to larger peers, and removes a dividend in the second half from forecasts. Buybacks are also removed from forecasts. Moreover, the broker agrees a capital raising at current levels would be highly detrimental to shareholders and the bank is likely to look for alternatives.

Bell Potter is disappointed and includes a lower final dividend in FY19 estimates as a measure of conservatism, even though the pay-out ratio is for up to 50% of underlying earnings.

The broker lowers the price target to \$2.20 and maintains a Hold rating. Despite a prospective price/earnings ratio of less than 5x Bell Potter does not think a Buy rating is warranted because of the numerous distractions for the company.

Even the most patient investors must be frustrated, Macquarie suggests, although the share price response appears excessive. The bank's capital position is weakened by -130-190 basis points, which is untimely given the Brexit crisis and the significant integration program with Virgin Money.

The company's self-help initiatives are considered the best of the UK banks, Citi acknowledges, with net interest margins being supported by a shift in the mix of asset & liability, and Bell Potter agrees the initiatives should



underpin the stock in the long run.

#### Payment Protection Insurance

What is PPI? Payment Protection Insurance has been sold aggressively by British banks and mis-sold to millions over many years. This is a short-term income protection package sold alongside mortgages, loans and credit cards and designed to re-pay borrowings if the person become sick or unemployed.

The policies have been highly profitable and the Financial Services Authority began imposing fines for the improper sale of policies, banning single premium PPI in 2009, and recently bringing in a new regulations for the sale of these policies.

If the Bank of England attempts to stimulate the UK economy by lowering the bank rate or using unconventional measures than this could also have adverse consequences for net interest margins as well as the AUD/GBP exchange rate from the perspective of investors in ASX-listed CDIs (CHESS Depository Interests), Morgans points out.

Nevertheless, risks are not all to the downside, which is why the broker retains a Hold rating. Avoiding any significant weakness in the UK economy means it is plausible that CYBG could generate a double-digit return on equity. The broker's target is \$2.11, reduced from \$3.16.

Macquarie currently forecasts a 10% return on equity by 2023 but recognises to achieve this level of return CYBG will need to execute on its strategy and macro conditions will need to improve.

Given a limited track record of generating organic capital, Macquarie also envisages a risk the regulator will impose higher capital buffers in the event of any issues with integration and any adverse Brexit outcome. The broker reduces its target by -25% to \$3 and maintains an Outperform rating.

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FNArena is proud about its track record and past achievements: Ten Years On

## Brokers Remain Hopeful Of A Retail Pick Up

Australia's retail sector is at a low ebb. An eagerly-awaited improvement is expected to emerge over the next 6-12 months and brokers assess which stocks may benefit.

-Subdued reporting season set aside in favour of improved outlook -Online trajectory expected to outpace total sales growth for a number of years -PE multiples re-rated as earnings downgrades were widespread

By Eva Brocklehurst

Multiple challenges exist for Australia's retail sector amid low levels of housing turnover, little income growth and an unemployment rate that is forecast to remain above 5% for at least the next year or so.

Most of any improvement is expected to come over the next few months from income tax rebates and lower interest rates, supporting disposable incomes. However, Macquarie suggests risks remain and a false sense of security may be emerging about the outlook for the Australian economy.

The broker acknowledges some signs that consumer circumstances are improving, although this is emerging from a very low ebb as the earnings performance of the listed consumer sector was one of the worst on record during the latest reporting season.

UBS found the results season polarising. Discretionary retail outperformed, with the market appearing to look through softer second half trends as the outlook was better. Staples were broadly in line with expectations while the food/beverage sector was disappointing.

Moreover, most retailers have reported positive like-for-like sales growth in FY20 to date, although, as yet, no retailer has called out tax cuts as a driver. Nevertheless, the broker expects tax cuts will provide improved retail sales growth over the next 6-12 months, and assuming around 50% of this is spent it would drive around one percentage points of retail sales growth.

UBS notes of the 14 retailers that reported, only five recorded an improvement in second half earnings (EBIT) growth versus the first half. The main disappointments were Harvey Norman ((HVN)) and Inghams Group ((ING)). UBS still assumes conditions will improve in FY20 for Harvey Norman.

Given improving housing conditions and a positive impact from tax rebates, Morgans expects updates at retailer AGMs will provide the next catalyst for the sector. The best potential, in the broker's view, relative to current expectations, lies with Accent Group ((AX1)), Beacon Lighting ((BLX)), Super Retail ((SUL)) and Michael Hill ((MHJ)). Macquarie agrees there has been some signs of better consumer activity at Beacon Lighting, Adairs ((ADH)) and Super Retail.

### Online Trajectory

At the results, nearly every retailer pointed to the persistence of strong online sales growth, while foot traffic was soft. The vast majority of like-for-like sales growth continues to be supported by online penetration, brokers note. Hence, online sales growth is expected to outpace total sales growth for years to come.

The highest level of online penetration rates, Morgans points out, were with Domino's Pizza ((DMP)), Adairs, Accent and Baby Bunting ((BBN)). UBS also notes the largest contributors to overall online growth in retail were Rebel Sport & Supercheap Auto (Super Retail) and Adairs.

Morgans also found gross margins among the consumer sector were more resilient, which suggests price increases are being passed through and/or competitor activity is contained. The worst performing segment of consumer discretionary stocks was automotive sales, because of high unit prices, the link to housing and the very discretionary nature of the product.

### Outlook

Over 2019 to date, the consumer sector has outperformed the market and Macquarie attributes this to a hefty re-rating of PE (price/earnings) multiples as earnings downgrades persisted. Nevertheless, the broker does not find the sector cheap and, while finding better value in discretionary retail versus staples, does not consider valuation is a driver.

Against this backdrop, Macquarie retains a preference for Coles ((COL)) over Woolworths ((WOW)) in staples and considers both Domino's Pizza and Treasury Wine Estates ((TWE)) have multi-year growth stories that offer offshore exposure at fair multiples.

Downgrades to earnings projections were widespread in the results, Macquarie points out, with only JB Hi-Fi ((JBH)) being meaningfully upgraded. JB Hi-Fi and Harvey Norman are considered too expensive and, the broker observes, operating leverage continues to slow.

Citi revamps its pecking order following reporting season, moving Michael Hill to number one, assessing the stock is trading at an undemanding 6x FY20 earnings per share. Beacon Lighting has also risen in the order, upgraded to Buy, while Lovisa Holdings ((LOV)) moves down to number six from number one, as currency headwinds and ongoing investment in new markets are likely to constrain short-term growth.

During reporting season UBS upgraded Super Retail, Myer ((MYR)) and Domino's Pizza to Buy and downgraded JB Hi-Fi to Sell. Upside risk is envisaged from Viva Energy ((VEA)), Domino's Pizza and a2 Milk ((A2M)), as the market appears to have taken a relatively pessimistic view on these stocks post the results.

Downside risks exist for JB Hi-Fi, Flight Centre ((FLT)), Kogan.com ((KGN)), Super Retail and Costa Group ((CGC)) as, UBS asserts, these have had share price movements which are more positive than their results warranted.

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FNArena is proud about its track record and past achievements: Ten Years On

## A-REITs Subdued Despite Low Bond Yields

Australia's real estate investment trusts, as a group, have outperformed the broader equity market but remain relatively subdued, largely because of the dominance of shopping centres.

-News flow very negative for shopping centres -Fund managers better placed in current yield environment - Moderating economic growth likely to impact on office leasing conditions

By Eva Brocklehurst

Operating conditions continue to vary among the segments of Australian Real Estate Investment Trusts (A-REITs). The headline valuation of the sector appears attractive, as history indicates a decline in bond yields means listed property outperforms broader equity markets.

Yet Macquarie points out, while this remains the case in 2019, the strength of the outperformance has been relatively weak, attributed in part to an A-REIT index which has significant exposure to retailing that, in turn, is facing uncertainty over cash flow.

Hence, the sector is not as defensive as it once was. The price/earnings multiple of the A-REIT sector is at a -0.8 percentage point discount relative to the ASX 200, having inverted from a 1.7 percentage point premium since May 2016.

Macquarie expects a decline in equity market volatility, as further cuts to official interest rates in the next 12 months provide for higher asset values and less volatility. In times of rising volatility, the broker observes the A-REIT sector typically outperforms. The FY19 reporting season has reinforced Macquarie's view on retail, as operating income growth was disappointing and occupancy costs rose.

Citi agrees the news flow has been very negative for retail and a further slowing of income growth is likely, amid growing evidence that shopping centre values are falling. The broker has maintained an increasingly bearish conviction on retail A-REITs.

Macquarie, too, remains cautious about the current leverage of retail vehicles and queries the active buybacks of both Scentre Group ((SCG)) and Vicinity Centres ((VCX)), downgrading the latter to Underperform recently. Moreover, Morgan Stanley lowers expectations for retail REITs globally, driven by a combination of rising fears of a recession and escalating trade wars that may adversely affect retailers.

While retail sales growth has shown some signs of life in the latest ASX reports, this has not translated into comparable income growth for many A-REITs, Baillieu asserts. The broker believes the outlook for the sector is skewed to double-digit earnings growth expectations for large-cap stocks such as Charter Hall ((CHC)) and Goodman Group ((GMG)).

### Fund Managers Highlighted

Meanwhile, Charter Hall, Goodman Group and Lendlease ((LLC)) have fund management platforms which continue to benefit from a lower-for-longer yield environment. This outlook for fund managers is superior to passive retail A-REITs, in Macquarie's opinion.

Citi observes earnings growth for the sector based on company guidance is around 4% and any surprises to the upside are becoming more concentrated, with only Charter Hall, Goodman Group and Charter Hall Long WALE ((CLW)) offering above-sector earnings growth.

Macquarie expects operating conditions for the office segment will be less positive, highlighting Dexus Property's ((DXS)) view that any moderation in economic growth would impact on leasing conditions.

Charter Hall's wholesale funds have been busy over August, forming a new joint venture that will co-own the leasehold of Chifley Tower in Sydney. JPMorgan notes Charter Hall will manage the tower and its funds under management have increased by \$1.8bn as a result.

The company, along with Abacus Property ((ABP)), has also entered into an agreement to acquire 201 Elizabeth Street Sydney from Dexus and Perron for \$630m on a 5% yield. Charter Hall, along with partners, will take a 68% stake in the tower and Abacus Property will acquire the balance.

Stockland Group ((SGP)) is recycling capital, selling a 50% stake in 135 King Street and the Glasshouse retail complex and using the proceeds to acquire the remaining stake in Piccadilly Centre.

Despite positive momentum in residential markets, Macquarie recently downgraded Stockland to Neutral, given a flat distribution outlook. The preferred residential exposures are Mirvac Group ((MGR)) and Peet & Co ((PPC)). Citi made one rating change post the reporting season, upgrading Mirvac to Buy. The broker believes the leading indicators for residential are pointing to a recovery but the impact on earnings may only emerge in FY21.

Lendlease is now the broker's top pick in the A-REIT sector and could significantly outperform post the sale of its engineering business. Citi's least preferred names are Scentre Group, BWP Trust ((BWP)) and Stockland.

#### Floor Space

South Africa's Woolworths Holdings is looking to rationalise the footprints of retailers David Jones and Country Road Group. Noting similar intentions from store chains Myer ((MYR)) and Big W ((WOW)), Macquarie suggests backfill will be difficult.

David Jones intends to reduce floor space by -20% by 2026 and has announced an onerous \$22.4m lease provision. This reduction in the footprint was originally intended to occur upon the expiry of leases but the company has indicated it will now proceed more aggressively.

Regional locations are likely to be targeted, as the company intends to reduce its exposure to lower demographic areas. David Jones has 47 stores in Australia, with 10 in regional locations. Scentre Group has the largest shopping centre exposure to David Jones, with 17 stores of which two are in regional locations.

Macquarie notes Scentre Group's David Jones weighted average lease expiry is nine years. Country Road Group is intending to reduce its footprint by -9% on a net basis by 2022 and achieve sales-based rents as opposed to fixed rents.

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## Diversity Paramount For Synlait Milk

Investors remain cautious about Synlait Milk, which has many irons in the fire as it works on diversifying its food service strategy. Major customer a2 Milk is also critical to the outlook.

-Gross margins step down in new a2 Milk contract -Valuation becoming more attractive but several risks remain - Lack of visibility on margins may count against the company for some time

By Eva Brocklehurst

Diversifying its business remains paramount for Synlait Milk ((SM1)), which has resisted providing infant formula volume guidance for FY20. The company is working on its food service strategy, with attention to cream, and is also looking at long-life dairy beverages at the liquids facility.

Improved throughput has occurred in the blending and canning operations in FY19. Sales volumes for powders and creams were also up 15%, which allowed for an additional 9% in milk processing over the year.

Lactoferrin sales increased 33% and are expected to increase further in FY20. The company anticipates growing profits at least at a similar rate to FY19, which implies 10% growth. Despite a strong second half in infant milk formula, the stock is down -27% on a year ago as investors focus on the outlook.

Credit Suisse considers the business well-placed for growth but accepts investors have glimpsed the downside, given the slightly disappointing FY19 result and cautious FY20 guidance. Hence, the lack of visibility, particularly on margins, may count against the company for a period of time.

### Margins

Credit Suisse also suspects investor caution may stem from gross margins taking a step down on the new a2 Milk ((A2M)) contract, and a lack of other higher-margin small customers.

The broker bewails the lack of visibility on margins, which complicates the investment case, while acknowledging the significant level of profitability, albeit largely on the back of one key customer, a2 Milk, which has, to date, traded margin for quality and certainty regarding the availability of manufacturing.

There was a NZ\$3.5m gross margin loss from commissioning issues associated with the new liquid facility. Macquarie was surprised by this, given the recent investor briefing did not allude to any issues and notes, despite increased throughput and efficiencies, the company failed to observe any operating leverage.

UBS attributes a drop of -9% in the gross margin in powders and cream in FY19 to a greater manufacturing discount provided to a2 Milk. Macquarie also estimates a2 Milk provided around 60% of total gross margin in FY19 and envisages continued margin pressure over the medium term from key customers.

Synlait Milk has secured just two major customers outside of its ingredients business, a2 Milk and Foodstuffs, the latter being a milk processing contract. Macquarie notes the top three external customers represent 66% of revenue.

Uncertainties also exist regarding registration for the company's Chinese brands. Akara and Pure Canterbury have passed the technical aspect but are awaiting site audits.

Citi points out the soft outlook and reduced disclosure for infant formula canning volumes may also reflect headwinds within the Chinese infant formula industry, notably e-commerce laws that have led to a decrease in daigou demand (goods purchased locally for sale in China), increased competition and declining Chinese birth rates.

UBS believes concerns have been largely addressed regarding the low initial returns from facilities development. Yet, while upside to valuation is becoming attractive, the broker retains a Neutral rating amid the key risk of lower daigou sales.

Synlait Milk is an owner of manufacturing facilities for third parties and has built a big overhead base around the assets while generating a valuation premium. Therefore, maintaining returns on capital and profitability growth is critical at these levels, Credit Suisse asserts.

The capital expenditure guidance of NZ\$130-150m is materially higher than Morgans expected for FY20. In part the difference reflects the timing and quantum of expenditure on existing growth projects. The company will now spend

NZ\$32m on building a dry goods store at Dunsandel to improve supply chain efficiencies, to be completed in September 2020.

#### Pokeno

The company has no doubt about its ability to move ahead with commissioning of Pokeno - auditors have assessed no provision is required - but resolution of the covenant may take some time and, as a result, weigh on investor mindsets, several brokers assert.

The plant is expected to be commissioned in the next few weeks, at first producing bulk ingredients but moving towards some infant milk base powders at the end of FY20. Initially, margins at this facility are likely to be lower than those currently achieved at Dunsandel.

Morgans is increasingly comfortable with the timeline for commissioning while acknowledging the capital intensity and challenges of pursuing new growth streams outside of the company's core business.

The acquisition of the Talbot Forest cheese business is likely to help the company manage its milk supply curve by providing an avenue for excess fat, the broker points out. FY20 cheese production guidance is 5000t and a modest contribution to gross profit is expected over FY20-22.

Bell Potter believes FY20-21 will be transforming years for Synlait Milk, with the commissioning of the Pokeno dryer, the Talbot Forest cheese plant, commercialisation of the Dunsandel liquids facility and secondary infant formula brand registrations.

The broker, not one of the seven monitored daily on the FNArena database, considers the fundamental appeal of the stock is unchanged, retaining a Buy rating with a \$10.75 target. Bell Potter cites the discount to global dairy peers and the fact the business houses arguably the most valuable asset in the Australasian infant milk formula sector, namely the a2 Milk China registration.

Macquarie maintains an Underperform rating but acknowledges the stock is getting closer to valuation. Upside risks involve a positive outcome from Chinese registration, Pokeno and the volume outlook for a2 Milk. FNArena's database has two Hold ratings and two Sell.

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## Material Matters: Gold, Coal, Oil & Copper

A glance through the latest expert views and predictions about commodities. Gold; platinum; thermal coal; oil; and copper.

-Gold equities underperform as gold prices head higher -Have thermal coal prices found a base? -OPEC likely to have no choice but continue production cuts -Market signals turning more positive for copper

By Eva Brocklehurst

### Gold

Citi has become more bullish about gold, anticipating the price could breach US\$2000/oz at some stage in the next year or two. This is based on lower nominal and real interest rates and the risk of a global recession. Moreover, rich equity and credit market valuations and strong buying activity in gold are supporting the gold market. Silver price forecasts are also raised in line with the new gold deck.

The broker points out day-to-day gold market sentiment can diverge from the bullish theme, which provides opportunities to buy the dip in gold, expected to occur this month during a technically-driven sell-off that is not fully supported by a material shift in global growth or policy trajectory.

Amid this new base case for gold, with prices forecast to average US\$1575/oz in the December quarter and to average US\$1675/oz in 2020, Citi adjusts its view of gold equities. The broker cautions that, while higher gold prices may be a signal of global macroeconomic concerns this may not be entirely good news for gold equities. Gold equities have sharply underperformed the yellow metal in the past month.

Citi warns that a surge in gold prices does not necessarily translate to gold equities if, for example in the case of a US recession, there is a general sell-off in other asset classes. In this scenario, gold investors could turn to ETFs (exchange-traded funds) or the physical metal to ride out devaluation.

Generally, those that will benefit from a rising gold price are also defensive and the broker's top pick in the ASX 100 is Northern Star ((NST)), upgraded to Buy from Neutral. Citi's view of Evolution Mining ((EVN)) and Newcrest Mining ((NCM)), both upgraded to Neutral from Sell, centres on concerns about the possible effects on gold production if the drought in eastern Australia continues over the medium term.

UBS reviews its gold sector valuations, using a spot price assumption of US\$1500/oz instead of a US\$1300/oz long-term gold forecast as well as greater differentiation in the cost of capital across stocks.

The broker calculates OceanaGold ((OGC)), upgraded to Buy, has the highest weighted average cost of capital because of the higher risks from the ongoing regulatory and access issues at Didipio in the Philippines. The share price has not lifted with the surge in the gold price over 2019 because of these issues, and implies no value for Didipio. Therefore, a potential resolution is almost a free option, in the broker's view.

UBS raises Regis Resources ((RRL)) to Buy because the stock has not shared in the rally in the Australian dollar gold price and the risks appear well and truly priced into the stock. Northern Star is also upgraded, to Neutral, and the broker assesses the valuation is fair, despite the strong production growth and exploration potential. Newcrest Mining remains a Sell-rated stock as it trades at a premium valuation and production/earnings are forecast to peak in FY20.

### Platinum

Citi is also bullish on platinum over the next 12 months, expecting an improvement in automotive demand. Some consolidation in platinum prices is expected late in 2019 before a potential increase to US\$1000/oz during 2020.

Citi suggests investment demand will be the leading driver of growth for platinum this year, but a bullish outlook is intact based on expectations of an eventual substitution of platinum for palladium and a recovery in automotive catalyst demand. The broker has had discussions that indicate many large South African fund managers which have palladium ETF holdings have started liquidating these and buying platinum ETFs.

### Thermal Coal



Macquarie has noted a rally in the price of thermal coal based on a new risk of a nuclear plant shutdown in France. The details of this risk are scarce, the broker points out, and there is likely to be support building for thermal coal anyway because of supply cuts.

France has warned of anomalies in the welds of some steam generators and components used in nuclear reactors. No indication was given for just how many of France's 58 reactors are affected.

Thermal coal supply has fallen for the first time since mid 2016 as Indonesia joined Colombia and the US in cutting surplus tonnage. Macquarie points out around one quarter of the global seaborne market remains loss-making at current prices, with most of these operations located in Russia, Indonesia and the US.

Pending further developments in France, the broker warns that the exit of loss-making thermal coal capacity at current prices only promises short-term stability, not significant upside. Still, after a year-long slide prices may have found a base.

## Oil

OPEC and allies are meeting to review oil production strategies. ANZ analysts suggest the group faces unprecedented uncertainty, particularly the tension between the US and Iran, as well as Venezuela. Trade tensions are also weighing on manufacturing activity.

Global vehicle sales, a key factor in gasoline demand, are on a trajectory to be down -6% in 2019. The analysts believe, with crude oil well below Saudi Arabia's target of US\$80/bbl, there is no choice but to continue with current production reduction agreements.

The ability to push prices higher appears limited. ANZ analysts reduce forecasts for oil demand growth to 1mb/d in 2019 and expect a sizeable drawing down of stocks in the December quarter. They will be watching for any impetus in Chinese infrastructure expenditure after authorities suggested a boost was required to offset a slowdown in economic growth.

## Copper

Morgan Stanley suggests demand for copper could resume as the market emerges from a seasonally-slow third quarter. Upside risk to the copper price is envisaged in a market that is still struggling to grow supply.

Non-commercial net short positions on COMEX reached all-time record levels recently as sentiment around trade tensions in the global economy deteriorated further. Prices have been subdued and a drawing down of inventory has filled the gap created by shrinking supply.

Morgan Stanley believes China is most likely source of a recovery in demand, noting market signals have turned positive. The cathode premium has risen to US\$77/t and bonded warehouse inventory has fallen by -150,000t over the last two months. Meanwhile constraints on mine supply continue. Glencore's decision to cut the remaining 100,000tpa output at Mutanda from early 2020 will offset some of the gains from a recovery in volumes at Escondida and Grasberg.

Morgan Stanley expects mine supply growth will be limited to around 1% following a contraction of -2% in 2019, keeping the market in deficit and providing more meaningful support for the copper price.

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## ESG Focus: The Rise Of The Vegan

FNArena's dedicated ESG Focus news section zooms in on matters Environmental, Social & Governance (ESG) that are increasingly guiding investors preferences and decisions globally. For more news updates, past and future: <https://www.fnarena.com/index.php/financial-news/daily-financial-news/category/esg-focus/>

### The Rise Of The Vegan

A vegan ETF is the latest offering in a burgeoning US ESG-based investment fund market increasingly targeting every ESG theme from climate change to Christianity.

-Vegan ETF launches in US -ESG-ETFs increasingly popular -Not without risk

By Sarah Mills

This week, the world's first vegan-friendly and climate-conscious Exchange Traded Fund (ETF) launched on the New York Stock Exchange, perhaps the most promising ESG thematic ETF launched to date given its strong food and fast-moving-consumer-goods bias.

Titled the Vegan Climate Index, ticker VEGN, it is an ethical stock that offers investors a fossil-fuel free, agro-chemical free and plastic-free investment option. Compared with the unscreened Solactive US Large Cap Index, the Vegan Climate Index has 61% less carbon, 89% less waste and 83% less water in its footprint, according to Impact Cubed Squared.

The launch is timely. According to The Economist in an article titled 'The Year of the Vegan', "2019 will be the year when Veganism goes mainstream." It was a sentiment reiterated in a Forbes article.

### Millenials drive vegan trends

The Economist points out that a quarter of 25-34 year-olds in the United States say they are vegans or vegetarians. And where the millenials lead, business follows.

Global vegan meat-market sales hit \$19.5bn in 2018, according to a report by Euromonitor International; the global vegan cheese market is forecast to hit \$4bn by 2024, according to the Vegan Society; and meat substitute sales grew 451% in the European market in the four years to February 2018, according to the University of Hohenheim.

### Transforming the food market

In 2040, it is estimated 40% of the global population will consume farmed meat, 35% will consume lab-grown meat and 25% will eat vegan replacements.

McDonalds now offers McVegan burgers, Ben and Jerry's offers vegan ice cream, KFC is offering vegan nuggets and burgers, dairy giant Danone recently invested \$60m in dairy-free products, and plant milks are widely available in global supermarkets.

Veganism sits within the wider trend of health foods and organic produce, which has also been experiencing stellar growth - one only has to think of A2 Milk.

While vegans represent a relatively low percentage of the population (generally less than 1.5% in any given population, although Israel has the highest population at between 5% to 8%), vegan products have a general appeal to vegetarians, who comprise roughly 25% of the global market and are an obvious market for vegan conversion.

### Regulators may step in

It seems veganism also stands to benefit from potential health regulation. The Los Angeles Schools District is now serving vegan meals in its schools, and several aged care institutions around the world are serving vegan menus to residents.

Like it or not, for ageing baby boomers, meat can be more hindrance than help and for institutions entrusted with residents' care, they may have a duty of care to make the shift. The American Medical Association recommended in 2017 that hospitals and medical associations should start serving vegan meals to patients.

There have also been some attempts to link veganism to climate change, with 24 EU members of parliament recently signing a letter requesting the EU move to a vegan diet to reduce greenhouse gas emissions. However, the science on this is in dispute.

Few arguments about personal care products

Less contentious than food or climate-change, however, is the potential market for fast-moving-consumer goods such as hair, facial, skincare and household cleaning products.

"Not tested on animals" is the most important packaging claim on personal care products for 57% of people. Beauty brands with cruelty-free certification account for 20% of women's face skincare products and the niche is growing at almost three times overall segment growth.

Launches for vegan facial and skincare products tripled between 2013 and 2018, growing from 13% of all launches in 2014 to 28% in 2018. Giant UK health beauty retailer Superdrugs' own-brand vegan cosmetics sale grew 750% in 2019. UK supermarket Tesco's sales of vegan cleaning products grew 80% in 2018.

A Market Research Future report predicts 6% sales growth for cruelty-free cosmetics between 2017-2023, and recent trends suggest this may be conservative.

The Vegan Trademark and accreditation scheme is well advanced and certification generally requires zero animal content (including vertebrates and invertebrates), zero animal testing, zero genetically modified organisms, and preparation standards wherein all vegan produce must be prepared separately and on separate surfaces and utensils.

But the crux of this story is not veganism, but ESG ETFs.

VEGN is a classic example of an ESG ETF

VEGN is a classic example of a thematic environmental governance and social (ESG) investing EFT, a group of investments that have experienced limited success to date.

Given past performance of thematic ETFs (ESG or standard), one could be forgiven for suggesting that those choosing to invest in a cause or a theme might be better served by a standard crowd-funder than a listed investment vehicle.

The above market analysis was primarily an exercise in determining whether VEGN has a better chance of escaping the fate of other ESG thematic ETFs, and if so, what characteristics might be those that can make the difference.

The FMCG link certainly increases VEGN's prospects markedly but much will depend on the direction in which funds are deployed. Investing in winning products or businesses could prove a boon, but using funds to force behaviours could be counterproductive.

If it is successful, it could prove a benchmark or model for future ESG thematic ETFs, and provide further direction for impact investing, vs exclusionary investing and best-in-class investing in the ETF field.

The underlying index targets mid-cap stocks in the hope that the sector will be more susceptible to leverage when the fund engages with its companies to remove animal products from business lines and improve vegan services. This reflects upon the fact that ESG thematic inflows are far too small to affect the behavior of large-cap companies. To date, the assumption that targeting mid-cap stocks may be a lever for revolution has yet to be tested.

Thematic ETFs and thematic ESG ETFs

VEGN is just one of many thematic ETFs to hit the market over the past decade. Typically, non-ESG ETF thematics have a strong technology bias, but the growing interest in ESG has recently witnessed a spate of environmental and social product launches.

Given its climate-conscious bias, VEGN falls squarely into ESG ETF territory. Morningstar says Information Technology is the number one ETF thematic, followed by the environment. Despite roughly \$4 trn invested in ETFs only \$13bn is invested in social investing.

ETF industry is booming

It is not surprising that ESG is pressing into the ETF space. The ETF industry is perhaps the greatest market success story in the past decade. Money has streamed from traditional investment vehicles such as mutual funds into ETFs.

Investors disillusioned by poor practices in traditional funds and high expenses have been lured by the low-fee exposure to baskets of stocks that offer a higher degree of liquidity, relative autonomy and set-and-forget appeal.

According to Independent ETF/ETP consultancy firm ETFGI, net global funds invested in ETFs hit US\$5.74 trn at the end of July 31, 2019. US\$60.19bn net inflows landed in July, (up1.7% on June) taking the yearly count to US\$269.73bn. The trend shows no sign of slowing.

ETFs: Vanilla, thematic, factored or tailored

And investors are literally spoilt for choice. They can choose a vanilla ETF based on a basket of cross-industry stocks, in a geography or market; or a thematic, which could range from something as standard as gold and resources; to a niche thematic such as cybersecurity, cloud computing, AI or cryptocurrencies.

And then, to quote the old National Australia Bank tagline, ETFs offer "tailored solutions" to investors. ETFs are a factor investor's paradise.

Factor investing is a strategy that chooses securities based on attributes that are associated with higher returns. It is used to enhance diversification, generate above market returns and manage risk. There are two main types of factors: macroeconomic and style factors.

"The former captures broad risks across asset classes, while the latter aims to explain returns and risks within asset classes," says Investopedia. "Some macroeconomic factors include credit, inflation and liquidity, whereas style factors embrace style, value, and momentum, large cap vs mid cap, risk (beta)."

ESG ETFs factoring on steroids

And ESG and ETFs were made for each other.

Like standard ETFs, ESG ETFs can be divided into thematics along either environment, social, or governance lines (or all of the above). They are also structured along standard ESG investment lines, as in best-in-class, exclusionary, or "impact investing". Then they can also be structured along all the standard ETF factors mentioned above, such as value, quality, momentum, style and volatility. The permutations and combinations are mind boggling.

Both standard and ESG EFTs aim to outperform the market by reducing volatility or boosting returns, according to Bloomberg: "Both are quantitative strategies which means they can be recast as a rules-based index and tracked cheaply by ETFs.

Nir Kassair in Bloomberg Opinion, describes ESG investing as factor-investing on steroids - there are many individual factors within each of the ESG umbrellas and each of them can be expressed in a myriad of ways.

Enter tailored ESG solutions

Factor-investing can be a useful way for evaluating ESG ETFs. VEGN, as an example, is an exclusionary fund but it is also an impact fund, but its approach to volatility and returns is less clearly delineated. This mismatch can be a problem for ESG investors, but that is where the benefits of the ETF format become clear. Not only can investors gain access to a series of basket of stocks, they can tailor their own ESGs exposures according to either their investment or philosophical viewpoint, or both.

Open Invest Co and Ethic Inc, for example, are two funds that allow investors to customise their portfolios. This trend is likely to grow. One can envisage an investor taking a large stake in a best-in-class ETF and supplement it with interest-areas such as veganism or climate change, or Christian values.

As VanEck Vectors MSCI International Sustainable Equity ETF managing director Arian Neiron says in The Australian Financial Review:

"The beauty of the ETF format (for ESG investing) is that if you don't agree with a particular exclusion, for example stocks whose underlying business relies on genetically modified organisms, you can buy VanEck Vectors MSCI International Sustainable Equity ETF but then add GMO companies to your portfolio."

ESG ETF taking a larger slice of the pie

ESG investing is carving out its own slice of the burgeoning ETP/EFT market, as impact investors, exclusionary investors and best-in-class investors, all jostle to stake their claim.

The annual Brown Brothers Harriman ETF industry survey found investors were expressing a greater interest in ESG ETFs funds, 51% citing it as at least somewhat important, vs 37% last year.

According to Investopedia, this reflects on evidence showing that ESG investing is a viable long-term investment with the potential to outperform traditional investments. They are also gaining traction as investors seek to reduce the risk of stranded assets as the carbon war looms.

ESG ETFs to benefit from responsible investing trend

ESG investing is now as much about making money and minimizing risks as it is about doing the right thing. Nine out of 10 Australians expect their super to be invested responsibly and ethically, according to RIAA.

ETFs are likely to be the recipient of a large percentage of these funds. Responsible investing differs to ethical investing in that the former adheres to ESG data that shows clear links to risk-minimisation and long-term profitability. Ethical investing tends to be exclusionary. Often the two overlap, with an ESG and exclusionary screen being applied.

ESG ETFs on the rise

There are now roughly 50 major ESG ETFs trading on the US sharemarket and it is estimated that ESG assets generally could comprise up to two-thirds of assets managed by global funds by 2020.

According to Bloomberg, funds under management in ESG-focused ETFs hit a record \$41.6bn, less than a third of the largest non-ESG fund.

In May, DWS launched the largest ESG ETF to hit the market in 15 years with fees as low as 0.11%, making it comparable with the most efficient vanilla ETFs.

Last year, Ossiam became the first European asset manager to launch a smart beta ESG ETF, which uses a machine-learning algorithm to rank companies based on their ESG status and financial potential.

It first applies an ESG filter to global large-caps and excludes all those that do not comply with the 10 principles of the UN Global Compact - and that's just the first filter.

MSCI boasts 1300 global institutional investors that use its ESG ratings and research, a trove that covers 650,000 securities and 8 million derivatives.

BNY Mellon believes this trajectory will continue and that ETFs may become the ESG vehicle of choice, given their transparency, low costs, and technological/research capital.

Niche ESG themes on the rise

Most of the inflows into ESG ETFs to date have been the type that fit into the responsible investing category - let's call them vanilla ESG ETFs. They are typically low-fee funds designed to minimise carbon risk with a best-in-class focus.

But thematic ESG ETFs such as niche VEGN are also on the rise. VEGN is one of several to be launched in recent years.

California-based Inspire Investing launched a ESG ETF with Christian values as a screen, complete with tag line: "Do you invest like a Christian?" which belongs to the biblical investing social cohort. The Global X S&P 500 Catholic Values ETF proved the highest netting social ETF in 2019.

The Gender Diversity Index ETF ((SHE)) invests in companies that display gender diversity in boards and managements. Invesco Solar is one of the oldest thematic ESG ETFs, specialising in solar energy stocks. There's a Low Carbon Target ETF, a Fossil Fuel Reserves Free ETF, the Long-Term Care ETF, global infrastructure ETFs, Waste Collection, Recycling, Health, and Soil Remediation, just to name a few.

The most popular thematic ESG ETFs tend to focus on the environment, and the number of clean energy ESG ETFs has been rising by double digits.

Unicredit Bank has just listed two ex-Nuclear Power Multi Factor and Minimum Variance indices (the former is higher risk, the latter is lower volatility).

Most other thematic ESG ETFs have seen zero to negative flows so far in 2019, despite many boasting low expense ratios of 0.2%.

The potential for ESG themes are endless: one can envisage legal ETFs that fund prospective lawsuits.

ESG ETFs have vastly varying risk profiles

Vanilla ESG ETFs - those focused on a best-in-class, broadly based index are designed to minimise risk, particularly carbon risk.

Not so thematic ETFs, which are generally exclusionary or based on positive-screening. The main risk is sector concentration. Environmental funds often display an overreliance on healthcare stocks and, more controversially, technology stocks, and the onus remains on the investor to check the underlying diversification in the ETF index.

ESG ETFs are less liquid than individual stocks, simply by the fact that there are less market makers per individual stock in the ETF. While the securities are sufficiently liquid under normal market conditions, the story can differ in a crash. Investors brought a class-action suit against Blackrock after a market decline in August, 2015, triggered trading halts and dozens of ETFs traded at sharp discounts to the sum of their holdings.

Then comes regulatory risk.

Still reeling from the securitisation-engineered global financial crisis, in which Europe fell foul of Wall Street's financial engineering practices, Europe has banned United States ETFs - a reflection of the separate regulatory environments governing the securities. Regulators across the world readily admit that they are playing catch-up with this rapidly growing market.

All the factor-investment potential mentioned above raises the spectre of the slicing and dicing that brought about the securitisation downfall. For example, A-REIT ETFs include mortgage pools as well as standard real estate.

Investors will need to ensure the underlying Index retains its integrity. Stocks in ETF indexes can change for any number of reasons.

Just last August, Vanguard eliminated a private prison operator GEO Group, a gun manufacturer Sturm Ruger, and Murdoch's media stocks, Yum Brands and GlaxoSmith Kline from its fund.

It was an error that caused these stocks to be included in the first place and highlights another risk: that ETFs and ESG funds failing to meet criteria could suffer reputation damage, or worse deal with regulators or lawsuits. Already several leveraged ETFs have suffered lawsuits relating to disclosure. The legal environment for ETFs is also evolving so investors cannot take anything for granted.

DWS Xtrackers S&P 500 ESG ETF ((SNPE)) tracks the S&P 500 ESG Index. S&P recently booted Facebook off for poor social and governance scores.

ESG ETFs also need to pass the consumer test. Greenwashing can be an issue, particularly for investors that are implementing an ESG screen to avoid risks surrounding stranded assets.

The onus remains heavily on the investor to vet the underlying stocks in the index, and monitor for changes.

Another interesting feature is that ETFs are allowed to lend their shares to other firms and earn interest. This adds another layer of complexity, as does the question of dividend payments.

There have also been instances in which management have stolen ETF funds.

### The problems with ESG ETFs

Thematic ESG ETFs not only have all the standard risks of standard ETFs, they have their own subset that correlates closely to thematic ETFs. The strength of any ETF Index rests heavily on the research supporting the theme (more so than that needed for ESG best-in-class screens). This makes it hard to evaluate the robustness of the strategy and difficult to compare them with peers - that's assuming they even have peers.

### Low success rate for thematic ETFs

About 35% of the thematic ETFs launched in Europe have already closed. This figure more than doubles for all thematic launches prior to 2012. Less than half of all equity ETFs have closed over the same period. History suggests that even if an investor clicks on to a winning theme, the funds don't survive long enough for them to benefit.

### ESG thematic ETFs are typically more expensive than best in class

ESG ETFs are expensive. VEGN, for example, sports a total expense ratio of 0.6%. This compares with less than 0.1% for the largest standard ETFs, and less than 1.5% for large best-in-class and exclusionary ESG ETFs. Roughly 75% of ETF inflows have been allocated to funds with an annual expense ratio of 0.2% or less, and the average large cap smart beta ETF is about 0.3%, according to Investopedia.

One article speculated that this reflects the heavy level of upfront research required, and that the costs may ease as a fund gains traction. It points out that iShare slashed its expenses on several ESG ETFs in early 2019.

Can ESG ETFs change the world?

In the end, ESG thematic ETFs are all about changing the world - at their core is the seed of revolution. However, research shows that ESG inflows are so small that large-cap companies are unaffected by current investment levels and ESG thematic investing is unlikely to change their behaviour. That situation is unlikely to change within the next three years. In the meantime, investors can expect the smorgasbord of investment options to keep flowing.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

## Australian Banks: Navigating The Mine Field

The Royal Commission has changed the face of Australian banking, the housing market bust has killed loan demand, and ever lower RBA rates are not much helping. Nor are increasing capital requirements.

-Better than expected earnings results -Ongoing margin pressure -Falling market share -More capital headwinds -The rise of the disruptors

By Greg Peel

Reporting Season

While Commonwealth Bank ((CBA)) was alone among the big three in officially reporting earnings in the August result season just past, the others provided updates to provide a picture of the state of play for Australian banks following a period of substantial upheaval. Upheaval which included the fallout from the Royal Commission, increased regulator scrutiny and capital requirements, the housing market bust and interest rates crashing around the globe.

Despite all of the above, investor sentiment for the major banks has remained relatively upbeat, Bell Potter notes. The analysts suggest this is due to the alignment of some positive factors amongst all the negatives.

The bank's underlying numbers were actually "surprisingly good", Bell Potter declares, although this may have a lot to do with market expectations being set very low. The Coalition's surprise win in the election was a confidence booster, given negative gearing is now untouchable, as are franking credit cash-backs.

APRA's relaxing of too-tight mortgage serviceability requirements has increased borrowing capacity, and RBA cuts help to relieve potential mortgage stress. While not that helpful for bank margins, the RBA cuts are at least offset by falling offshore rates, meaning lower funding costs.

At the end of the day, who doesn't love a good yield?

Of Rocks and Hard Places

It looks like the Australian housing market may have turned the corner, which we can attribute to the above list of positive factors. Up until this week bank analysts were cautious about suggesting the bottom has now been seen, and about just what sort of rebound would transpire. There was no expectation of an immediate reinflation of the prior housing bubble.

Then along came this week's housing finance numbers for July, which left analysts rather shocked at the extent of the spike. It appears loan demand is back.

Average bank loan growth is currently in the range of 2-3%, Shaw & Partners notes. Bank earnings are driven predominantly by the net interest margin (NIM) banks can achieve from the spread from their average rate of funding cost (deposits and borrowings) to their average lending rate. But while a lower RBA cash rate is a positive for loan demand, too low is an issue for NIMs. Banks cannot offer a deposit rate of zero.

The good news is the RBA is not Robinson Crusoe. Around the world, central bank cash rates are dropping like stones. The Fed has cut once this year and is expected to do so again next week. The ECB is expected to cut further into the negative tomorrow night and perhaps even reinstate QE. The Bank of Japan supposedly stands ready.

The further global cash rates fall, the more attractive Australian bank debt (these days predominantly convertible bonds) appear to offshore investors, meaning our banks can offer lower rates to lenders. This provides an offset to the problem of a too-low domestic cash rate.

But the bad news is also stacking up.

Firstly, on the other side of the ledger, bank costs are rising. The majors were already in the process of spending heavily on IT to drag their management systems kicking and screaming into the twenty-first century. Then along came the RC. Now the banks have to spend heavily to be able to satisfy increased and more frequent scrutiny from the regulator. And they have to meet the regulator's new capital demands, to the extent, Shaw & Partners notes, that required capital growth is exceeding loan growth.



Secondly, not only did the RC result in such regulatory headwinds, it also opened the door to the competition. Let's just say the RC didn't go a long way to enhancing the reputation of Australia's longstanding majors.

Shaw & Partners believes that even if the RBA cash rate goes to zero, it will not necessarily be a poor outcome for the banks. However, investors will be unlikely to enjoy any share price appreciation, just dividends.

UBS remains cautious on the banks, finding it difficult to foresee any upside. UBS has focused on the issue of competition.

Would the last bank customer to leave...

While the slowdown in mortgage approvals since 2017 is well documented, UBS notes (as regulations were tightened and the housing market soon rolled over), the decline in the major banks' mortgage sales is "stark". Branch mortgage approvals have fallen by a third since 2015.

The majors currently account for only 37% of mortgage sales, down from 48% in 2013. UBS estimates ANZ Bank's ((ANZ)) proprietary sales have now fallen to just 4% of all system approvals, down from 9% in FY13. National Bank's ((NAB)) approvals have fallen to 8% from 13% and Westpac's ((WBC)) to 9% from 11%.

CBA's share has surprisingly remained stable at 15%, despite the bank arguably being the Big Bad Wolf of the RC, and even beforehand.

There has not been much in the way of existing mortgage holders shifting to other lenders, nonetheless, probably because their mortgages were approved when assessments were far more lax pre-RC, and they might risk being rejected under post-RC strictness. The majors still control 79% of existing mortgages, known as the "back book", but competition is heating up for new mortgages, known as the "front book".

Reputational damage post RC is likely to accelerate this trend, UBS suggests.

With a front book share well below their back book share, the majors' loan growth is likely to continue to lag the overall system. The banks attempt to prop up their NIMs by not fully passing through further RBA rate cuts to mortgage rates, but any benefit may quickly be eroded, UBS points out, as mortgage brokers find cheaper loans elsewhere for their customers.

Beyond the matter of new loans, that lack of existing loans shifting to new lenders may also turn around if proposed new rules applying a "duty of best interest" upon mortgage brokers has them out finding new and cheaper mortgages for customers, particularly if annual reviews become "best practice".

If sales out of bank branches continue to diminish, this will put pressure on the majors to rationalise their costly branch footprints. But this may result in a negative feedback loop, UBS warns - who wants to borrow from a bank which has no nearby branch?

UBS goes as far as to ponder whether the majors may simply become mortgage underwriters to the competition rather than mortgage distributors themselves. If so, this could drive bank return on equity towards their cost of capital.

All up, sufficient reason for UBS to remain "cautious".

And loan growth is just part of the problem.

Australia v. New Zealand

Hanging over the heads of Australia's majors in recent months has been an intention by the Reserve Bank of New Zealand to increase the capital requirements of banks operating in the country, that is the level of capital banks assign to their New Zealand operations. Australia's banks have already been hit by APRA's new "unquestionably strong" capital requirements, and just when they thought they were now safely on target, along come the Kiwis.

All four majors have operations in NZ, but one is substantially more exposed than the other three. They don't call it the Australian & New Zealand Banking Group for nothing.

The RBNZ has yet to make up its mind about exactly what that capital requirement should be, but the decision became a lot more complicated last month when APRA countered with a new rule for Australian banks (as of January 2021).

Since the GFC, APRA has been concerned that given today's global banking system is so intertwined, chaos theory can come into play. The collapse of one small operation somewhere in the world can potentially trigger a chain reaction across the entire global banking system, and a subsequent financial collapse. This is what we saw in 2007-08. What started as an initially trivial scare in the US sub-prime mortgage market led to the US government having

to step in and bail out the US banking system with taxpayer funds. JPMorgan was forced to acquire Bear Stearns. Bank of America was forced to acquire Merrill Lynch.

Lehman Bros was left to the wolves.

The problem for APRA is it has little to no control over banking jurisdictions outside of Australia, and thus would be unable to prevent another round of GFC contagion reaching these shores. The regulator now wants Australian banks to regularly update on “step-in” risk - the risk it (or RBA or government) may have to “step in” to stop an Australian bank going under.

The only way APRA can retain some control over that which it has no control - foreign subsidiaries - is to limit the amount of capital Australian banks can commit to foreign subsidiaries as a percentage of total capital. Call it a “buffer”.

Do you see where this is going? APRA is in the gold jersey running left to right. The RBNZ is in the black jersey running right to left.

From the beginning of 2021, Australian banks will only be permitted to commit 25% of tier one capital offshore, down from 50% today. It now matters not what requirement the RBNZ may desire.

#### Australia & New Zealand

Last month ANZ Bank sold its 55% stake in a banking joint venture in Cambodia. Just as well. The sale was in line with an intention to simplify the bank’s Asian exposure down to fully-owned operations only. ANZ has a presence in 14 different jurisdictions in the region. Of those, 13 are insignificant as far as APRA is concerned.

As the Citi bank analysts see it, ANZ is the largest Australian bank in NZ, with the largest problem and the least number of solutions. The other three are less exposed so the APRA/RBNZ conflict is not so much in play. The issue for ANZ is one of the RBNZ’s new capital requirement exceeding the 25% of offshore allocation APRA will allow.

It will likely end up a problem for the RBNZ, which may simply have to come up with a concessionary solution.

Meanwhile, all four banks will need to act to meet RBNZ’s proposed levels. Citi suggests this can be done by, among other things, repricing NZ loans by an average 35 basis points and cutting NZ dividend payout ratios to 35% from 80%. There is scope to absorb much of the capital at group level, the analysts believe, but lower dividends back from NZ will keep Australia-only capital ratios tighter than the banks had previously assumed in their progress towards “unquestionably strong”.

As ANZ Bank attempts to reduce its offshore exposure to 25%, any material capital return for shareholders will likely result in a breach. Hence Citi believes a buyback has now been scuttled. CBA has enough headroom to continue with capital management.

Westpac is the one bank for which analysts in general believe the dividend payout ratio is already unsustainably elevated. So before the NZ factor, this ratio is under question. Citi believes it will not be NZ capital requirements that force a cut to the ratio, but rather bad debts.

Bank dividend levels will be under pressure if credit stress - which has been historically low ever since the initial GFC wash-out - returns to haunt. The good news is RBA cuts, and more to come, along with a housing market that appears to be on the mend and still relatively low unemployment, reduce the likelihood of a spike in credit stress.

That said, Australian households are mortgaged up to their eyeballs at historically low rates. A recession would not be helpful right now.

#### Bad Advice

It is not only customers who have been abandoning the majors. So too have banks’ wealth management advisors, post-RC. And in this instance the Big Four becomes the Big Six - we can include AMP ((AMP)) and IOOF Holdings ((IFL)).

924 financial advisors left the wealth management businesses of the Big Six over the three months to end-August. This record exodus has occurred, Bell Potter notes, despite the Big Six already having seen their advisor base reduce in recent years, from 39% of the sector in October 2016 to 28% last month.

FY19 was the “year of shock” for wealth management, thanks to the Royal Commission and the subsequent sudden rush to reduce fee levels the RC had exposed as being bordering on criminal. Bell Potter believes the shift in the sector will be on “in earnest” in FY20.

This is all the major banks need - a loss of fee income alongside a loss of NIM income. The RC sparked an immediate cascade of lower fees as the rush was on to retain customers. If the RC did nothing else, it thrust previously little known wealth management “disruptors” into the spotlight. Those who already exist in the New World and who inhabit cyberspace rather than operating an expensive network of branches.

The good news for the shareholders of the major banks is the banks have already responded to the inevitable. Westpac is in the process of exiting the financial advice industry. CBA is largely on its way out. ANZ Bank is in the process of selling most of its business to IOOF.

Thus IOOF has gone the other way, and to boot has also finalised a purchase of Bendigo & Adelaide Bank’s ((BEN)) adviser network. The offset is nevertheless a divestment of around 300 advisers from its Ord Minnett network.

Any loyalty the likes of AMP and IOOF once enjoyed has now evaporated, not just from customers but from advisors. This is feeding an industry shift to independence, playing right into the hands of the fledgling independent platform space.

AMP and IOOF are now in the midst of a multi-year reform process. Bell Potter sees AMP as further into the process, having set aside “meaningful” provisions against the RC-fallout and set about rebasing its pricing. IOOF has taken an initial step towards provisions, but there will be more to come, the analysts warn.

Suffice to say Bell Potter has Sell ratings on both. On the flipside, the broker has Buy ratings on the independent upstarts Netwealth Group ((NWL)), Praemium ((PPS)) and OneVue Holdings ((OVH)).

Bell Potter is not one of the seven brokers in the FN Arena broker database. As far as the banks are concerned, the database brokers line up their ratings and consensus forecasts as such:

FN Arena Major Bank Data FY1 Forecasts FY2 Forecasts Bank B/H/S Ratio Previous Close \$ Average Target \$ % Upside to Target % EPS Growth % DPS Growth % Payout Ratio % Div Yield % EPS Growth % DPS Growth % Payout Ratio % Div Yield WBC 3/3/1 28.85 28.78 - 1.17 - 13.5 - 1.8 90.4 6.3 8.7 - 1.8 81.7 6.2 NAB 3/3/1 28.03 26.93 - 5.45 - 5.0 - 16.2 81.1 5.8 5.3 0.4 77.3 5.9 ANZ 1/4/2 27.20 27.69 1.67 4.5 0.2 69.2 5.9 - 6.3 0.4 74.1 5.9 CBA 0/3/4 79.81 72.44 - 9.33 0.9 0.0 87.9 5.4 3.4 - 2.0 83.4 5.3

Between them, the seven brokers can only scrape together seven Buy ratings across the Big Four, against eight Sells. Thirteen Hold ratings suggest a balance of the pros, such as yield, and cons, such as, well, just about everything else.

The table has a familiar look to it, if several years of FN Arena’s tabulation are anything to go by. CBA is perennially considered to be overvalued (trading 9% above consensus target), yet perennially remains that way, because apparently size does matter. The more recent outperformer within the sector has been NAB, which still commands three Buy ratings to CBA’s none despite being 5.5% above consensus target.

ANZ, NAB and Westpac all close their books at the end of this month, and report in November. In between we are expected to see one more RBA rate cut. Maybe even two.

#### Technical limitations

If you are reading this story through a third party distribution channel and you cannot see charts included, we apologise, but technical limitations are to blame.

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FN Arena is proud about its track record and past achievements: Ten Years On

## Weekly Ratings, Targets, Forecast Changes - 09-09-19

By Rudi Filapek-Vandyck, Editor FNArena

Guide:

The FNArena database tabulates the views of seven major Australian and international stock brokers: Citi, Credit Suisse, Macquarie, Morgan Stanley, Morgans, Ord Minnett and UBS.

For the purpose of broker rating correlation, Outperform and Overweight ratings are grouped as Buy, Neutral is grouped with Hold and Underperform and Underweight are grouped as Sell to provide a Buy/Hold/Sell (B/H/S) ratio.

Ratings, consensus target price and forecast earnings tables are published at the bottom of this report.

Summary

Period: Monday September 2 to Friday September 6, 2019 Total Upgrades: 6 Total Downgrades: 6 Net Ratings Breakdown: Buy 37.02%; Hold 46.09%; Sell 16.90%

The August reporting season is done and dusted and overall activity among securities analysts as measured by upgrades and downgrades for individual ASX-listed entities has fallen to single digits for each for the week ending Friday, 6th September 2019. No surprises here.

Fittingly, FNArena registered six upgrades and six downgrades. Five of the upgrades moved to Buy, while three of the downgrades became a fresh Sell rating. The unlucky receivers of the latter are Collection House (disappointing result), CSR (still no improvement for building materials) and Harvey Norman (disappointing result).

The news becomes increasingly more positive as we zoom in on positive changes for broker's price targets with eternal phoenix Myer claiming top spot for the week, enjoying a target increase of no less than 32.6% after a positively received results report. At a distance follow the likes of Western Areas, FlexiGroup, Appen, and Woolworths.

On the negative side, the largest reduction was for the two gold producers St Barbara and Northern Star, followed by Orocobre (lithium), Incitec Pivot (profit warning) and another gold producer, Regis Resources.

The real fireworks was reserved for changes to earnings forecasts which are, on both sides, considerable. On the positive side sits Myer on top, followed by Freedom Foods Group, Western Areas, Austal, and Village Roadshow.

On the negative side, where reductions on average are larger, we find NextDC, Orocobre, TPG Telecom (results release), Incitec Pivot, and Senex Energy.

Things should quieten down significantly post August and with out-of-season results releases few and far between, but this assumes the absence of further profit warnings a la CYBG on Thursday last week, which followed a profit warning from Incitec Pivot 48 hours earlier.

Upgrade

CLASS LIMITED ((CL1)) Upgrade to Add from Reduce by Morgans .B/H/S: 2/1/0

Class has decided to reduce its single-product reliance on Class Super, its SMSF management software system. Expanding the product range will require higher investment capex in the shorter term, Morgans notes, weighing on earnings.

The move is not without risk but if successful, Class should become a more attractive growth investment, Morgans believes. The broker has made multiple changes to its forecasting and valuation models, which lead to a target price increase to \$1.41 from \$1.34, and a double-upgrade to Add from Reduce.

INCITEC PIVOT LIMITED ((IPL)) Upgrade to Buy from Neutral by Citi .B/H/S: 4/3/0

Citi analysts had already warned investors about the apparent downside risk to the company's guidance for FY19 so yesterday's profit warning from the company did not come as a surprise. What did surprise was the magnitude of the downgrade.

Citi analysts now note management has announced a strategic review of the fertiliser business. Citi analysts think finding a buyer for the whole operation might prove a challenge, but the distribution business with circa 50% market share in Australia's East will definitely attract interest, in their view.

Market forecasts are poised to reset lower, but Citi also finds that, with the share price at a three year low, the risk reward proposition for owning this stock has turned favourably again, hence the upgrade to Buy from Neutral. Target price remains unchanged at \$3.45.

MYER HOLDINGS LIMITED ((MYR)) Upgrade to Accumulate from Lighten by Ord Minnett .B/H/S: 2/2/1

The company will report its FY19 result on September 5. Ord Minnett expects underlying net profit of \$35.6m, up 9.5% with sales down -2.5%. The broker upgrades to Accumulate from Lighten and raises the target to \$0.70 from \$0.42.

Ord Minnett notes the range is being optimised to drive gross margins as the company turns its range towards new and exclusive brands that should support sales. Myer is also addressing costs while improving its supply chain.

PUSHPAY HOLDINGS LIMITED ((PPH)) Upgrade to Hold from Lighten by Ord Minnett .B/H/S: 1/1/0

Ord Minnett observes the stock price has retraced -25% since the FY19 result. The broker believes expectations now reflect a more realistic view of the company's addressable market and earnings potential.

While the fundamental view is of an increasingly competitive market, the broker acknowledges a Lighten rating is no longer valid and upgrades to Hold. Target is raised to \$3.08 from \$2.92.

WESTPAC BANKING CORPORATION ((WBC)) Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 3/3/1

Credit Suisse upgrades to Outperform from Neutral as the stock is trading at a 10-year low in terms of sector-relative valuation. The broker expects two of the three items weighing on the stock should be resolved in the coming quarter i.e. capital and dividend sustainability.

The broker believes this could be dealt with at the upcoming result with a capital raising in the order of \$1.5-2bn and a -10-15c per security reduction in the semi-annual dividend.

While asset sales are possible, Credit Suisse believes the timing of completion means more urgent action on capital is required.

The broker does not suggest Westpac will completely abandon the multi-brand strategy but a consolidation of some of the brands would provide a cost opportunity. Target is raised to \$30.55 from \$28.60.

WESTERN AREAS NL ((WSA)) Upgrade to Overweight from Equal-weight by Morgan Stanley .B/H/S: 3/3/0

News reports suggest Indonesia is moving ahead with new regulations and bringing forward an export ban for nickel with grade less than 1.7%.

Morgan Stanley estimates around 218,000t of Indonesian nickel-in-ore, or 9% of global mined supply, is exposed to the ban. If this nickel ore is left stranded the market would move into substantial deficit.

The broker envisages high upside risk for nickel versus forecasts and Western Areas becomes the preferred nickel exposure.

Rating is upgraded to Overweight from Equal-weight. Industry view is Attractive. Target is raised to \$3.30 from \$2.25.

Downgrade

3P LEARNING LIMITED ((3PL)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 0/2/0

3P Learning's result missed Macquarie's Forecast by -13%, with the core A&NZ business impacted by execution issues and competition. Europe et al saw earnings declines due to Brexit and contract losses, while the Americas did okay, albeit assisted by the currency.

Recent licence trends have tempered FY20 growth expectations, the broker notes, with concerns raised as to whether A&NZ has "peaked". Management is confident of improvement, but the broker expects the market will require evidence of this to provide for any re-rating. In the meantime Macquarie downgrades to Neutral. Target falls to 90c from \$1.50.

COLLECTION HOUSE LIMITED ((CLH)) Downgrade to Reduce from Hold by Morgans .B/H/S: 0/0/1

Underlying net profit in FY19 was up 7.4%, largely driven by a lower implied amortisation rate. Morgans assesses, if it were not for this and applying the same amortisation rate as FY18, underlying net profit would have been down -39%.

The broker was looking for improved cash generation and this was absent in FY19. If operating performance improves there is upside in the longer term but the broker also assesses the downside risk is significant.

Rating is downgraded to Reduce from Hold and the target lowered to \$1.09 from \$1.42.

CSR LIMITED ((CSR)) Downgrade to Lighten from Hold by Ord Minnett .B/H/S: 1/0/4

Ord Minnett reduces forecasts for the building products division in FY20 and FY21 to better capture the economics of the company's key business units during a downturn.

The main positive is the balance sheet, which places CSR in a strong position whereby it can potentially pick up assets along the way if the opportunity arises.

Ord Minnett reduces estimates for earnings per share by an average of -4% over the forecast period. The impact from lower building product margins and property earnings is partially offset by upward revisions to the aluminium division.

Rating is downgraded to Lighten from Hold and the target reduced to \$3.50 from \$3.80.

GTN LIMITED ((GTN)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 0/1/0

GTN's -37% drop in profit had been pre-released. The Australian Traffic Network was the key driver of weakness, Macquarie notes, and with earnings visibility clouded there is no end in sight at present.

Management appears to be taking the right steps but clear evidence of sustained stability is required to restore investor confidence. Macquarie downgrades to Neutral from Outperform. Target falls to 85c from \$1.35.

HARVEY NORMAN HOLDINGS LIMITED ((HVN)) Downgrade to Lighten from Hold by Ord Minnett .B/H/S: 0/4/1

FY19 results, which were below forecasts, indicate an investment phase has commenced for the company's franchisees. Lower sales drove higher levels of tactical support. This meant franchising pre-tax profit was reduced in the second half.

Ord Minnett notes the external environment in some locations internationally is challenging, while tough comparables are an issue in the NZ division.

Given the challenges, valuation support is reduced in the broker's view. While the final dividend was well above forecasts, Harvey Norman announced another entitlement offer, which Ord Minnett suspects reflects a desire to retain low levels of gearing.

Rating is downgraded to Lighten from Hold and the target is \$4.

METALS X LIMITED ((MLX)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 0/1/0

Macquarie believes declining tin prices will force a funding squeeze for Metals X and the broker is now assuming a \$20m capital raising. Updated reserve estimates have led to a cut in earnings forecasts.

Cuts to production, and the dilution of a raising, lead the broker to cut its target to 16c from 30c. Downgrade to Neutral from Outperform.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 CLASS LIMITED Buy Sell Morgans 2 INCITEC PIVOT LIMITED Buy Neutral Citi 3 MYER HOLDINGS LIMITED Buy Sell Ord Minnett 4 PUSHPAY HOLDINGS LIMITED Neutral Sell Ord Minnett 5 WESTERN AREAS NL Buy Neutral Morgan Stanley 6 WESTPAC BANKING CORPORATION Buy Neutral Credit Suisse Downgrade 7 3P LEARNING LIMITED Neutral Buy Macquarie 8 COLLECTION HOUSE LIMITED Sell Neutral Morgans 9 CSR LIMITED Sell Neutral Ord Minnett 10 GTN LIMITED Neutral Buy Macquarie 11 HARVEY NORMAN HOLDINGS LIMITED Sell Neutral Ord Minnett 12 METALS X LIMITED Neutral Buy Macquarie Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 APX APPEN LIMITED 67.0% 33.0% 34.0% 3 2 QAN QANTAS AIRWAYS LIMITED 60.0% 33.0% 27.0% 5 3 DOW DOWNER EDI LIMITED 75.0% 50.0% 25.0% 4 4 SDF STEADFAST GROUP LIMITED 50.0% 25.0% 25.0% 3 5 MYR MYER HOLDINGS LIMITED 10.0% -10.0% 20.0% 5 6 A2M THE A2 MILK COMPANY LIMITED 25.0% 7.0% 18.0% 6 7 CGC COSTA GROUP HOLDINGS LIMITED

60.0% 42.0% 18.0% 5 8 WSA WESTERN AREAS NL 50.0% 33.0% 17.0% 6 9 NXT NEXTDC LIMITED 75.0% 58.0% 17.0% 6 10 SXY SENEX ENERGY LIMITED 50.0% 33.0% 17.0% 4 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 SBM ST BARBARA LIMITED -100.0% -63.0% -37.0% 3 2 RRL REGIS RESOURCES LIMITED -100.0% -71.0% -29.0% 5 3 NST NORTHERN STAR RESOURCES LTD -80.0% -67.0% -13.0% 5 4 S32 SOUTH32 LIMITED 71.0% 83.0% -12.0% 7 5 QUB QUBE HOLDINGS LIMITED -25.0% -14.0% -11.0% 4 6 CAR CARSALES.COM LIMITED 25.0% 36.0% -11.0% 6 7 FXL FLEXIGROUP LIMITED 50.0% 60.0% -10.0% 4 8 CCL COCA-COLA AMATIL LIMITED -67.0% -57.0% -10.0% 6 9 MYX MAYNE PHARMA GROUP LIMITED -33.0% -25.0% -8.0% 3 10 HVN HARVEY NORMAN HOLDINGS LIMITED -25.0% -17.0% -8.0% 6 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 MYR MYER HOLDINGS LIMITED 0.658 0.496 32.66% 5 2 WSA WESTERN AREAS NL 3.042 2.558 18.92% 6 3 FXL FLEXIGROUP LIMITED 1.973 1.788 10.35% 4 4 APX APPEN LIMITED 28.997 26.330 10.13% 3 5 WOW WOOLWORTHS LIMITED 32.166 30.228 6.41% 5 6 DOW DOWNER EDI LIMITED 8.370 7.970 5.02% 4 7 QAN QANTAS AIRWAYS LIMITED 6.350 6.108 3.96% 5 8 A2M THE A2 MILK COMPANY LIMITED 14.625 14.180 3.14% 6 9 HVN HARVEY NORMAN HOLDINGS LIMITED 3.995 3.877 3.04% 6 10 SXY SENEX ENERGY LIMITED 0.443 0.432 2.55% 4 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 SBM ST BARBARA LIMITED 2.920 3.365 -13.22% 3 2 NST NORTHERN STAR RESOURCES LTD 9.280 9.883 -6.10% 5 3 ORE OROCOBRE LIMITED 3.620 3.829 -5.46% 6 4 IPL INCITEC PIVOT LIMITED 3.423 3.591 -4.68% 7 5 RRL REGIS RESOURCES LIMITED 4.640 4.859 -4.51% 5 6 SVW SEVEN GROUP HOLDINGS LIMITED 20.533 21.183 -3.07% 3 7 S32 SOUTH32 LIMITED 3.240 3.330 -2.70% 7 8 SFR SANDFIRE RESOURCES NL 6.950 7.114 -2.31% 6 9 CGC COSTA GROUP HOLDINGS LIMITED 4.136 4.228 -2.18% 5 10 MYX MAYNE PHARMA GROUP LIMITED 0.557 0.568 -1.94% 3 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 MYR MYER HOLDINGS LIMITED 87.260 3.810 2190.29% 5 2 FNP FREEDOM FOODS GROUP LIMITED 14.867 7.933 87.41% 3 3 WSA WESTERN AREAS NL 24.288 15.155 60.26% 6 4 ASB AUSTAL LIMITED 20.733 16.100 28.78% 3 5 VRL VILLAGE ROADSHOW LIMITED 14.233 11.133 27.85% 3 6 BIN BINGO INDUSTRIES LIMITED 10.133 8.800 15.15% 3 7 WOW WOOLWORTHS LIMITED 139.733 129.414 7.97% 5 8 CMW CROMWELL PROPERTY GROUP 8.033 7.733 3.88% 3 9 APX APPEN LIMITED 49.330 47.933 2.91% 3 10 QAN QANTAS AIRWAYS LIMITED 65.278 63.732 2.43% 5 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 NXT NEXTDC LIMITED -3.917 -0.117 -3247.86% 6 2 ORE OROCOBRE LIMITED 0.475 2.924 -83.76% 6 3 TPM TPG TELECOM LIMITED 25.839 37.056 -30.27% 6 4 IPL INCITEC PIVOT LIMITED 8.510 12.033 -29.28% 7 5 SXY SENEX ENERGY LIMITED 1.103 1.485 -25.72% 4 6 LNK LINK ADMINISTRATION HOLDINGS LIMITED 31.446 37.153 -15.36% 7 7 SIG SIGMA HEALTHCARE LIMITED 1.838 2.048 -10.25% 4 8 OML OOH!MEDIA LIMITED 17.068 18.974 -10.05% 4 9 CGC COSTA GROUP HOLDINGS LIMITED 16.036 17.363 -7.64% 5 10 TCL TRANSURBAN GROUP 20.883 22.550 -7.39% 7 Technical limitations

If you are reading this story through a third party distribution channel and you cannot see charts included, we apologise, but technical limitations are to blame.

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## Uranium Week: Positive Outlook

The outlook for the world nuclear power industry is positive, attendees at a symposium learned last week.

-Uncertainty continues to subdue activity -Positive presentations at nuclear symposium. -Reactor construction continues globally

By Greg Peel

Nuclear power generation company FirstEnergy Solutions last week filed a lawsuit in the Ohio Supreme Court to block a referendum seeking to overturn the state's planned nuclear subsidy. A coalition called Ohioans Against Corporate Bailouts is attempting to collect a required number of signatures on a petition to include a referendum in the 2020 presidential ballot.

The OACB argues the subsidy the Ohio government plans to provide to nuclear power in the state, funded by surcharge on electricity customers, equates to a tax, and state law prevents issues of tax being decided by referendum.

This legal battle only underscores the difficulty facing President Trump's Nuclear Fuel Working Group, which is due to report next month. How can the federal government best manage a US nuclear power industry that is uncompetitive amidst power alternatives, a US uranium production industry that is uncompetitive amidst uranium imports, and the fact decisions regarding subsidies fall under state laws?

All in the name of national security.

Activity in the uranium market was again muted last week as participants awaited the Working Group report, and pondered the uncertainty of an evolving White House position on waivers of Iranian sanctions and the Russian Suspension Agreement, which involves anti-dumping.

Switched On

Activity was always going to be impacted nonetheless by the annual World Nuclear Association symposium which drew market participants to London for the week. Several presentations by industry leaders and the release offered positive outlooks on the prospects for nuclear energy, industry consultant TradeTech reports. Combined with notable investor interest at the conference, hopes for increased demand for nuclear power were widespread.

To that end we note both South Korea and China switched on new reactors last week, Russia won the licence to build the second of four reactors planned for Turkey, Russia is now working on the construction of India's third and fourth reactors, with 20 more planned over the next 20 years, and a French mining company formed a partnership with the government of Uzbekistan to explore for uranium.

Activity in the uranium spot market last week was limited to three off-market transactions totalling 600,000lbs U3O8 equivalent, TradeTech reports. The consultant's weekly spot price indicator has risen US5c to US\$25.35/lb.

One transaction was reported in term markets, with further interest emerging. TradeTech's term price indicators remain at US\$28.00/lb (mid) and US\$30.00/lb (long).

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## The Short Report - 12 Sep 2019

### Guide:

The Short Report draws upon data provided by the Australian Securities & Investment Commission (ASIC) to highlight significant weekly moves in short positions registered on stocks listed on the Australian Securities Exchange (ASX). Short positions in exchange-traded funds (ETF) and non-ordinary shares are not included. Short positions below 5% are not included in the table below but may be noted in the accompanying text if deemed significant.

Please take note of the Important Information provided at the end of this report. Percentage amounts in this report refer to percentage of ordinary shares on issue.

Stock codes highlighted in green have seen their short positions reduce in the week by an amount sufficient to move them into a lower percentage bracket. Stocks highlighted in red have seen their short positions increase in the week by an amount sufficient to move them into a higher percentage bracket. Moves in excess of one percentage point or more are discussed in the Movers & Shakers report below.

### Summary:

Week ending September 5, 2019

Back to normal programming this week, after the ASIC debacle of the prior two.

Last week saw the ASX200 run up very hard to end a volatile August and then fall back down again for the start of the new month.

Only a handful of reds and greens for last week, which is more typical, but there were three stocks which enjoyed short position falls of one percentage point or more and yes, all can be explained.

In a tale of two earnings result responses, we saw Inghams Group ((ING)) shorts fall to 15.0% from 17.3% and Bega Cheese ((BGA)) shorts fall to 9.3% from 10.6%. Those responses were nevertheless in contrast. See below.

Western Areas ((WSA)) shorts fell to 5.7% from 7.2%. Bit of a no brainer. See below.

A special nod this week to a newbie at the bottom of the table, although if memory serves I believe we have seen it there before - Fortescue Metals ((FMG)).

Weekly short positions as a percentage of market cap:

10%+ NUF 18.6 GXY 16.7 ORE 16.4 ING 15.0 BAL 14.8 SYR 14.5 NXT 14.5 JBH 13.0 HUB 11.4 GWA 11.1 BWX 11.0 DMP 10.4

Out: PLS, BGA

9.0-9.9

BOQ, IFL, PLS, HVN, MTS, BIN, BGA, RWC, SGM

In: PLS, BGA Out: CGC 8.0-8.9%

IVC, CGC, BKL, SUL, OML, PPT, DCN

In: CGC, OML Out: SDA

7.0-7.9%

SDA, CLH, MYR, AMP, CGF, CSR

In: SDA, CSR Out: OML, WSA

6.0-6.9%

A2M, NCZ, PGH, KGN, SFR, GEM, NEC, COE, CTD

Out: NWL, WEB

5.0-5.9%

SAR, LNG, CLQ, GMA, NEA, WSA, CUV, FMG, MSB, WEB, ELD, SXY, SEK, ALG, EHL, NWL

In: WSA, WEB, NWL, SAR, FMG, ALG, EHL

#### Movers & Shakers

The week prior, Inghams Group sat in second place on the most shorted list behind Nufarm ((NUF)). Both we can call “drought stories”.

Bega Cheese is another agri-stock, although dairy farms are mostly further south and closer to the coast, away from the worst drought-affected areas, so it is questionable as to whether we can call this a drought story, albeit the shorts did line up at 10.6%.

The difference between the two is that Bega provided a profit warning heading into results season and Inghams didn't. Inghams' weak result was thus severely punished on the day and the share price has not since recovered, while Bega's result met downgraded guidance and the stock has since rallied.

In Inghams case shorters profits took care of the sellers, (15.0% shorted down from 17.3%) while in Bega's case it appears short-covering helped lift the stock price (9.3% from 10.6%).

Switching from farming to mining, last week the Indonesian government announced it was bringing forward its planned ban on nickel ore exports, thus reducing global supply and sending the nickel price soaring. This is the second round of bans from Indonesia, which is trying to move up the value-add chain by becoming a nickel processor and not just a rock exporter, offering incentives to domestic and foreign companies to construct smelters.

Clearly the first ban was not sufficiently successful.

As the listed nickel miner most leveraged to the nickel price, Western Areas ((WSA)) has rallied 38% since the announcement, while another beneficiary Independence Group ((IGO)) also enjoyed a 30% rally. Mixed miner South32 ((S32)) has risen 12%.

Western Areas shorts have fallen to 5.7% from 7.2%, and may have further to go.

#### ASX20 Short Positions (%)

Code Last Week Week Before Code Last Week Week Before AMC 0.7 0.8 RIO 4.6 4.2 ANZ 0.6 0.6 S32 1.1 1.0 BHP 3.6 3.4 SCP 0.9 0.9 BXB 0.1 0.0 SUN 0.9 0.8 CBA 1.1 1.1 TCL 0.4 0.4 COL 0.9 0.7 TLS 0.2 0.3 CSL 0.2 0.2 WBC 0.8 1.0 IAG 0.6 0.6 WES 1.0 1.0 MQG 0.5 0.7 WOW 0.9 1.4 NAB 0.4 0.4 WPL 0.9 0.9 To see the full Short Report, please go to this link

#### IMPORTANT INFORMATION ABOUT THIS REPORT

The above information is sourced from daily reports published by the Australian Investment & Securities Commission (ASIC) and is provided by FNArena unqualified as a service to subscribers. FNArena would like to make it very clear that immediate assumptions cannot be drawn from the numbers alone.

It is wrong to assume that short percentages published by ASIC simply imply negative market positions held by fund managers or others looking to profit from a fall in respective share prices. While all or part of certain short percentages may indeed imply such, there are also a myriad of other reasons why a short position might be held which does not render that position “naked” given offsetting positions held elsewhere. Whatever balance of percentages truly is a “short” position would suggest there are negative views on a stock held by some in the market and also would suggest that were the news flow on that stock to turn suddenly positive, “short covering” may spark a short, sharp rally in that share price. However short positions held as an offset against another position may prove merely benign.

Often large short positions can be attributable to a listed hybrid security on the same stock where traders look to “strip out” the option value of the hybrid with offsetting listed option and stock positions. Short positions may form part of a short stock portfolio offsetting a long share price index (SPI) futures portfolio - a popular trade which seeks to exploit windows of opportunity when the SPI price trades at an overextended discount to fair value. Short positions may be held as a hedge by a broking house providing dividend reinvestment plan (DRP) underwriting services or other similar services. Short positions will occasionally need to be adopted by market makers in listed equity exchange traded fund products (EFT). All of the above are just some of the reasons why a short position may be held in a stock but can be considered benign in share price direction terms due to offsets.

Market makers in stock and stock index options will also hedge their portfolios using short positions where necessary. These delta hedges often form the other side of a client's long stock-long put option protection trade, or perhaps long stock-short call option ("buy-write") position. In a clear example of how published short percentages can be misleading, an options market maker may hold a short position below the implied delta hedge level and that actually implies a "long" position in that stock.

Another popular trading strategy is that of "pairs trading" in which one stock is held short against a long position in another stock. Such positions look to exploit perceived imbalances in the valuations of two stocks and imply a "net neutral" market position.

Aside from all the above reasons as to why it would be a potential misconception to draw simply conclusions on short percentages, there are even wider issues to consider. ASIC itself will admit that short position data is not an exact science given the onus on market participants to declare to their broker when positions truly are "short". Without any suggestion of deceit, there are always participants who are ignorant of the regulations. Discrepancies can also arise when short positions are held by a large investment banking operation offering multiple stock market services as well as proprietary trading activities. Such activity can introduce the possibility of either non-counting or double-counting when custodians are involved and beneficial ownership issues become unclear.

Finally, a simple fact is that the Australian Securities Exchange also keeps its own register of short positions. The figures provided by ASIC and by the ASX at any point do not necessarily correlate.

FNArena has offered this qualified explanation of the vagaries of short stock positions as a warning to subscribers not to jump to any conclusions or to make investment decisions based solely on these unqualified numbers. FNArena strongly suggests investors seek advice from their stock broker or financial adviser before acting upon any of the information provided herein.

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## The Wrap: Economy, Utilities & Building

Weekly Broker Wrap: economic outlook; online classifieds; integrated utilities and building materials.

-RBA cash rate forecast to descend to 0.5% by February 2020 -Online property listings improve although growth absent -Lower pool prices suggest risk to the downside for power retailers -Decline in vacant land sales signals downside risk for housing approvals

By Eva Brocklehurst

### Economic Outlook

National Australia Bank economists now factor in an additional reduction in the Reserve Bank of Australia's cash rate in February 2020, to take the cash rate to 0.5%, at which point the RBA is likely to signal intentions regarding unconventional monetary policy.

The next reduction of -25 basis points is still expected in November 2019, taking the cash rate to 0.75%, but the possibility of a reduction as soon as October cannot be ruled out if there is further weakness in the labour market.

Westpac economists expect that by the time of the October meeting, the US Federal Reserve will have reduced the federal funds rate further and, in turn, this will restrict the impact on the Australian dollar of recent rate reductions by the RBA. This state of affairs will then signal a need for further action.

A reduction in official cash rates in October of -25 basis points, from the current 1.0%, also leaves the RBA the option of a further reduction in December should conditions worsen, particularly in the global environment. Westpac economists also expect another -25 basis points cut in February 2020.

Unless the federal government delivers a meaningful fiscal stimulus, a further reduction to 0.25% for the cash rate is then forecast by NAB economists for mid 2020. To date, the government has focused on the objective of returning the budget to surplus. NAB economists continue to envisage a need for additional fiscal stimulus through new infrastructure investment, cash hand-outs and/or the pulling forward of tax cuts.

Their forecasts reflect downside risks to the domestic economy and greater uncertainty regarding the world economy. Growth continues to undershoot forecasts and inflation remains stuck below the RBA's 2-3% target band.

Public spending is strong but private demand has fallen for the first time since the global financial crisis. The NAB August business survey revealed no easing of the downward momentum in private demand and internal data indicates rate cuts and tax refunds have done little to boost consumer spending in July and August.

House prices may have picked up in a number of cities, which could limit further wealth effects, although leading indicators suggest the sharp downturn in residential construction could deepen.

The business survey indicates there has been little contribution to growth from the business sector outside of mining. Business confidence in conditions remain weak and well below long run averages, although still positive. Indicators suggest a turnaround in conditions is not imminent, as forward orders are negative and capacity utilisation well below levels seen 12 months ago.

Despite the gloom, NAB forecasts are for GDP growth of around 1.7% in 2019 and 2.25% in 2020. The unemployment rate is expected to rise slightly, reaching 5.5% late in 2020. The economists point out RBA growth forecasts remain at least 0.5 percentage points stronger than their projections.

Westpac economists agree the real economy has deteriorated and the details in the latest GDP report are disturbing. Output grew by just 0.5% in Australia in the June quarter while annual growth slowed to 1.4%, the softest pace since the GFC. Westpac forecasts for annual GDP growth are 2.3% in December 2019 and 2.4% in December 2020.

Global indicators of growth, trade and manufacturing are all showing signs of slowing, beginning to have a more material impact on confidence and labour market conditions in the US.

Hence, the Westpac economists now expect the US Fed to fulfill expectations of an easing over the remainder of 2019 and make two additional reductions in 2020, taking the federal funds rate to 0.875% by mid year. Other central banks are also poised to add stimulus.

## Online Classifieds

Online property listings continue to improve although there is no growth versus the same period in 2018. For the four weeks to September 8, capital city new listings were down -15.7%. UBS also notes the decline in total listings is accelerating, a function of growing buyer demand and a relatively low listing of new stock.

The broker expects REA Group ((REA)) and Domain Holdings ((DHG)) are already factoring in a gradual improvement in new listings, anticipating a return to growth in the second half of FY20.

## Integrated Utilities

Pool prices are the largest single driver of electricity market earnings, Morgan Stanley points out, while retail transfers have, historically, been only a minor input. Churn away from incumbents is down -23% in the year to date to absolute levels not seen since 2003.

Meanwhile, the closure of the Hazelwood power station led to a price increase, but backwardation of the forward curve - where the spot price is higher than the forward price -- has not eventuated to date. Delays in commissioning, rising fuel costs and increased intermittency from both thermal producers and renewable entrants played their varying parts.

The broker's latest analysis of "daylight" discounts shows that these prices are -10% lower than in the previous autumn-winter period. Therefore, the backwardated forward curve continues to be used in Morgan Stanley's estimates.

Pool price reductions of -\$5-20/megawatt-hour across the states in the national electricity market are forecast. This would create operating earnings (EBITDA) headwinds in the order of -14% for AGL Energy ((AGL)) and -7% for Origin Energy ((ORG)). The risk is skewed to the downside as lower pool prices persist, the broker adds.

## Building Materials

Vacant land sales in the main growth corridors have continued to decline, now near a 10-year low, UBS notes. Moreover, land sales appear to lead detached housing approvals by nine months. Hence, this signals downside risk for detached housing approvals towards a trough of 80-90,000 in early 2020. UBS suggests this could partly explain the dip in approvals in July and the August numbers will be scrutinised.

One potential factor that may offset this trend is excess land inventory. The broker assesses building material suppliers such as Adelaide Brighton ((ABC)), Boral ((BLD)) and CSR ((CSR)) carry increased earnings risk if housing approvals trough or are sustained below 170,000, as competition would rise and margins come under pressure.

However, UBS remains constructive, expecting the trend to improve in 2020 as house prices and clearance rates are rising. The broker remains wary of Adelaide Brighton's 2019 guidance, as it implies no further deterioration in the second half. For those with Australian exposure UBS prefers Boral.

If earnings risks lift for locals, the broker expects interest will move towards those stocks with more US exposure. In this case James Hardie ((JHX)) is preferred, as it is taking market share, while Reliance Worldwide ((RWC)) faces Brexit uncertainty.

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## Treasure Chest: Imdex Unrivalled

FNArena's Treasure Chest reports on money making ideas from stockbrokers and other experts. Imdex has an unrivalled position in mining instrumentation and Bell Potter initiates coverage on the stock.

-Leveraged to growth in global expenditure on mining, particularly gold -New products have potential to materially increase returns -Higher stock multiples can be expected

By Eva Brocklehurst

Imdex ((IMD)), which provides instrumentation for mining, has an unrivalled range of products, and benefits from a network of customers which integrate with its platform of proprietary applications. Hence, the company is well-positioned to realise the benefits of its R&D, currently commercialising a new product and with two others on track to be launched soon.

Bell Potter believes these three products have capacity to generate material growth in revenue, initiating coverage on the stock with a Buy rating and \$1.60 target. Any certainty surrounding earnings from the new technology would result in material upgrades to the broker's estimates from FY21.

The view is supported by increasing gold exploration and supply deficits in copper as well as expanding market share and margins. The broker also suggests the company's patents and intellectual property act as a barrier to entry.

While Imdex is leveraged to growth in global exploration expenditure, Bell Potter also notes that future resource discoveries will be deeper and require more advanced systems, providing further support to the business. The business is at a significant inflection point, the broker asserts, as the current price of the stock only values existing growth and there is a free option on new technology.

The success of the CoreVIBE instrument alone has potential to materially increase returns and dividends in the near term. The company provided no specific guidance at its FY19 results in August, although noted its first CoreVIBE units went on rent in the first quarter of FY20.

Moreover, a successful commercialisation of the multi-sensor Last Dog in the second half of FY20 would represent significant diversification in the production cycle, which Bell Potter notes would address a market that is much larger and less variable than exploration alone.

UBS found the outlook in the FY19 results positive and agrees the favourable gold price will support junior mining activity and, in turn, Imdex. The broker considers the stock price undemanding and retains a Buy rating and \$1.55 target.

The company is in transition, to reflect mining technology rather than just mining services, and Canaccord Genuity agrees this should attract higher multiples, particularly with early signs of a recovery in small-mid cap gold mining activity.

Margin outperformance made up for a revenue result that was below expectations in the second half and further margin upside should be forthcoming as the mining cycle continues to improve. Given this, Canaccord Genuity has a Buy rating and \$1.35 target.

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## Treasure Chest: AGL Mired In Uncertainty

FNArena's Treasure Chest reports on money making ideas from stockbrokers and other experts. An earnings contraction may hold AGL Energy back in FY21, as the electricity generation market remains mired in uncertainty.

-Risks from regulation, pricing pressures and ageing power plants weigh -Electricity sector amassing a growing list of unknowns -Cash generation likely to support buybacks, unless a telco opportunity presents

By Eva Brocklehurst

Are expectations for AGL Energy ((AGL)) still too high? The company has outlined several issues prevailing over FY20, including the outage at Loy Yang 2. However, Citi believes this explains just 10% of the reduced net profit guidance, which at \$822m is -21% below the prior year.

Citi suspects earnings contraction might still hold the company back in FY21, expecting net profit of \$717m, around -12% below consensus forecasts. The difference is likely because Citi is not forecasting an entire reversal of the impact of the Loy Yang 2 outage, when the plant comes back on line in FY21, stemming from lower electricity prices and the expenditure associated with repairs.

AGL has also quantified higher depreciation in FY20, which emphasises the age of the assets in its portfolio, Macquarie points out. Morgans agrees, assessing fundamentals are bleak for the longer term and becoming harder to ignore. Risks from re-regulation, pricing pressures and the ageing of the power plants - AGL's coal generation fleet is 38 years old - are expected to weigh on the stock regardless of any short-term support from the current share buyback.

UBS is more positive, believing the \$650m on-market buyback in FY20 should support the share price, although acknowledges the headwinds from regulation and lower long-term wholesale electricity prices. The challenges are considered priced in and, in the wake of the FY19 results, UBS upgraded to Neutral.

Citi calculates the fair multiple for AGL, at a 13.2x PE (price/earnings), is well below that implied by the current share price. Hence, the broker reiterates a Sell rating, suspecting investors for growth are unlikely to be compelled by what is on offer. As AGL pays dividends as a 75% pay-out of earnings per share in income, Citi suspects funds may be better off seeking value in stocks where dividends are not backtracking.

Moreover, value investors may not be getting enough margin of safety. The company's ability to generate cash is not the issue and the balance sheet may be able to afford acquisitions of scale. Rather, Citi believes investors are simply treading carefully in the current environment.

In retail electricity the broker is positive about the longer-term benefits to earnings if competition is reduced in a semi-regulated environment, but still expects some pressure. This stems from heightened competition in Queensland and Victoria, which may lead to either continued loss of market share or margin contraction, although not to the extent of recent years.

UBS suspects electricity prices will remain elevated through the 2019-20 summer and this should support AGL's share price. Nevertheless, there are concerns that prevailing market and policy settings will limit the company's ability to source and execute on attractive growth projects.

Ord Minnett takes a similar approach, assessing that, with earnings re-based lower, there are reasons to be positive. The stock is offering a 5-5.5% dividend yield and there is some evidence of market share gains in terms of electricity retail customer numbers. Moreover, the slump in earnings could ease political scrutiny of the company.

Morgans asserts there is a growing list of unknowns for the electricity sector. Regulation will become topical in FY20 as the government renews an attempt to pass legislation in order to wield a "big stick" over electricity providers. While unlikely to be triggered, Morgans points out this would have a huge negative impact on the sector if it were ever used.

The company has identified around \$1.5bn in projects to provide flexible capacity, although the majority will not be developed before 2022. AGL Energy has also emphasised a long-term need for the Newcastle gas plant as the market transitions to renewables but, clouding the outlook, is the issue of when that need emerges.

Macquarie notes, making this even harder, is additional transmission capacity and Snowy Hydro 2.0 on the 2025-2030 horizon. Moreover, the company's gas portfolio could struggle as legacy contracts roll off and margins come under

pressure.

The company generates strong cash flow, yet the broker points out there are limited opportunities for expenditure as projects are still 2-3 years away from final investment decisions (FID) and near-term FID will suffer from uncertainty over government policy, which is undermining any projected economics.

Hence, cash generation will support buybacks, unless management finds a significant telco opportunity. In the meantime, the valuation is yet to become compelling for the broker.

FNArena's database has three Hold and four Sell ratings. The consensus target is \$18.16, suggesting -4.3% downside to the last share price. Targets range from \$16.28 (Citi) to \$19.50 (Macquarie). The dividend yield on FY20 and FY21 forecasts is 5.3% and 5.2% respectively.

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## The Right Lessons To Learn

Dear time-poor reader: The All-Weather Portfolio is generating more income while better protected against share market shenanigans. Here's how we did it.

In this week's Weekly Insights:

-A Joke For The Times -The Right Lessons To Learn -Yield At Uncorrelated Protection -Rudi Talks -Rudi On Tour

Special note: there will be a Part Two comprising of broker Conviction Calls and remaining insights from the August reporting season, which will be published on Friday on the website.

A Joke For The Times

It is the year 2525, and man is still alive, but he's had to battle raging bush fires and rising sea water levels among many other impacts from climate change.

The world is now divided over three competing populist dictatorships that battle each other for what is left in fresh water and other crucial resources.

And the UK is considering organising its next referendum to decide whether it wants to leave the EU, or not.

(I recently told this joke while co-MC-ing the Conference Dinner with Julia Lee at the AIA National Investment Conference on the Gold Coast).

The Right Lessons To Learn

By Rudi Filapek-Vandyck, Editor FNArena

Probably the best way to describe the performance of the FNArena/Vested Equities All-Weather Model Portfolio into the new financial year is by making the following observation: the All-Weather Portfolio has rallied to a fresh all-time record high, while key local share market indices might need half a week of unrestrained upside to get there.

The difference in performance has been achieved on the back of yet another heavily polarised August reporting season in which yet again sharp differences were laid bare in operational performances between companies often operating inside the same sector.

This has now happened so often in recent years, investors should probably start asking the question as to whether we are experiencing a "new normal" for corporate Australia, and for investors trying to balance risks and potential rewards.

Quality, The New Diversifier

Citi analysts, in a post-August sector update on REITs in Australia, formulated it succinctly when they observed: "Earnings growth and upside surprise [are] becoming more concentrated".

This is not just something that characterises listed property stocks in Australia today. This observation equally applies to other sectors, like retail and miners. A clear case can be made that the Australian share market in its entirety is now sharply divided between Haves and Have Nots, with significant consequences for anyone looking to invest long term.

The most significant observation, on my assessment, is that a relatively low valuation increasingly corresponds with higher operational risks. Certainly, this has probably always been the case, but in the past your typical bottom dwellers and value investors seemed to get away with "buying cheaply" more often than not, as the share market always shoots first and share prices tend to overshoot to the downside.

Not anymore. The August reporting season had barely finished or share prices for Incitec Pivot ((IPL)) and CYBG ((CYB)) had yet to endure another profit warning from company management. The first one was pretty much anticipated as fertiliser prices remain lower-for-longer, but it still surprised to the downside. The latter warning came completely out-of-the-blue.

Which is why CYBG's share price shellacking was so much worse than how the market responded to Incitec Pivot's disappointment. Equally important: since Incitec Pivot is a highly cyclical business, contrarian investors have already

started speculating whether this latest disappointment marks the bottom for this cycle?

To be fair, August included some spectacular sell-offs for High Performance Achievers including a2 Milk ((A2M)), IDP Education ((IEL)) and Nearmap ((NEA)), but in most cases this happened on the back of a mere "technicality" such as management deciding to invest more to secure more growth further out, or the initial underperformance of a recent acquisition. It would be an incredibly brave call to now conclude these companies have turned ex-growth.

Fast growers can end up in dire straits, there's no denying the obvious, and August showed that once companies get mired into serious struggles it's best to adopt a cautious and conservative approach. See Blackmores ((BKL)) and Bellamy's ((BAL)), for instance, but also 3P Learning ((3PL)), Ardent Leisure ((ALG)), Arq Group ((ARQ)), The Citadel Group ((CGL)), Bega Cheese ((BGA)) and a whole battery of other examples.

The underlying observation remains intact though: most profit warnings and serious disappointments stem from challenged companies and from business models under pressure. Most often these are the share prices that lag the upward momentum that has allowed the Australian share market to rise more than 20% year-to-date.

### High Quality Continues To Prove Its Value

For years now I have been advocating investors should distinguish "High Quality" from the rest in the Australian share market. Those who have been following my market observations and analyses would have noticed there were no profit warnings from High Quality structural growth companies such as CSL ((CSL)), REA Group ((REA)) or ResMed ((RMD)); an observation that extends beyond the recent August reporting season.

In addition, I also believe investment strategies are best served by distinguishing the emerging disruptors from the increasingly disrupted. A substantial part of the polarisation in equities that started taking shape around 2014 can be explained by looking at the investment landscape from such perspective.

Here I believe the August reporting season has provided investors with an important piece of insight: many of the companies that fall either under the umbrella of "High Quality" or of "emerging structural growth" on the back of technological disruption are able to continue to grow their sales and profits, even during times of global deceleration, macro uncertainty and widespread corporate duress.

This is why I disagree with those strategists who believe the better valued segments of the share market -High Quality & Growth- shall turn into major victims when the proverbial hits the fan.

The August reporting season has once again provided plenty of evidence risk is most prevalent among the lowly valued peers that are struggling most and most likely to issue a profit warning when the squeeze is on. Looking into the past and assuming investors will automatically seek safety among lowly valued, but more vulnerable businesses, seems way too simplistic to me.

Having said this, investors still need to take into account that were panic to hit financial markets again, smaller cap stocks will still take a bigger hit than large cap stocks simply because of the flow of money.

And stocks that are perceived to be trading at an elevated premium might be hardest hit initially. During the Big Sell-Off in late 2018, there were times when virtually nothing offered genuine safety other than cash and gold, and indeed, government bonds (but not necessarily corporate credit).

That too should be a valuable lesson learned.

### Yield At Uncorrelated Protection

Probably one of the most surprising observations is that, on a net basis, money continues to flow out of US equities with much of it finding a new home in government bonds - at historical low rates.

US market strategists at Citi recently observed the broad S&P500 index in the US has risen beyond 60% (total return) over the past five years, yet US-oriented equity mutual funds and ETFs have seen cumulative net outflows over that same period of -\$300bn.

In similar fashion, most of the market updates and strategy reports I read over the past two months or so are mentioning elevated risk and why investors should build a buffer in cash, just in case. Most fund managers I read have been increasing cash in portfolios. Yet equities, both locally and overseas, always seem to find a way to resume the uptrend.

It seems counter-intuitive or is this why they call it the most hated bull market in history? Certainly, a simple "it's the weight of money" won't do as a satisfying explanation.

No time to be complacent

Share markets can still grind or rally higher, there is no doubt about that, and I see such forecasts on a daily basis, but I also agree with the majority voice this is not a time to be overly complacent about the risks that potentially lay ahead.

Early 2016 and late 2018 might be distant memories now, but they did happen, and there is absolutely no guarantee something similar cannot happen again (despite the fact the Fed is no longer tightening, which is a major difference).

We have as yet seen no reason to move significant volume out of equities and into bonds, gold and cash. So to prepare the All-Weather Model Portfolio for (potentially) a tougher environment ahead, I decided to look for non-share market correlated ways to protect against capital erosion while also lifting the overall income profile for the Portfolio as a whole.

All of a sudden, I found myself in exact the same position as many retirees who only recently decided to put more cash to work, only to find themselves caught in between a rock and a hard place; fearing a major correction in equities might do a lot of damage to their capital base, but at the same time, they need extra income.

The problem with seeking yield in today's share market is that most quality income providers are well-priced, while those still offering a reasonable yield in most cases come with higher risk operationally, which is why their share prices have lagged. Investors pay attention because this is how ALL financial markets work, including bonds and corporate credit. Higher yield/income means by definition higher risk.

Not making things any easier is the impartial observation that most financial assets have had a great run over recent years, and real value without excessive risk might well have become the Unicorn of our time. Certainly, there are scenarios at hand whereby all major assets -government bonds, corporate credit, equities and property values- can end up losing one's capital, all at the same time.

Is it still possible to find true diversification in one's portfolio while adding capital protection and extra income?

#### Searching For Yield, While Not Ignoring Risk

I think the answer is still positive. The FNArena/Vested Equities All-Weather Model Portfolio has re-allocated most of its cash into income generating assets that, on my assessment, should not follow the share market downwards in case of major risk-off volatility, while also generating an attractive, steady income. These are listed assets.

Firstly, so we are all on the same song sheet, the All-Weather Portfolio had kept a relatively large allocation in cash throughout the final months of 2018 and the first half year of 2019. We had moved some cash back into the market, but rather selectively. Most of that cash has contributed positively to the (out)performance into the new financial year.

Apart from carrying 18%-19% in cash, which we park inside a cash ETF, we also owned two investments, including a corporate bond expiring in less than 18 months, which we no longer wanted to own. All in all, we decided we have around 20% that can be re-allocated with the double aim of generating extra-income while also buffering the Portfolio for when times get hairy in the share market. We are still running circa 5% in cash, while receiving additional income from paid out dividends.

After conducting my research, which included rejecting a large number of options that failed to meet the criteria, sometimes by simply looking up the price chart for the past years (we explicitly don't want share market synchronicity), we decided upon the following re-allocations:

-Gold ETF -Gryphon Capital Income Trust (GCI) -MCP Master Income Trust (MXT) -Perpetual Credit Income Trust (PCI)

These four additional investments now account for circa 19% of the Portfolio. Add the cash and about one quarter of the Portfolio is currently not invested in the share market and, on my assessment, equally non-correlated with any share market turmoil.

Gold, of course, doesn't generate any cash income, but it functions as a contra insurance policy when all other financial assets threaten to go to hell in a basket. The three new income generating assets have lifted the average forward looking yield profile of the All-Weather Portfolio to above 3%, plus franking.

Mind you, at 3% yield/income this Portfolio now has become an ideal vehicle for retirees looking for an alternative avenue other than simply buying Australian banks, Telstra and a handful of other yield stocks in the share market. I intend to write a more detailed assessment of this statement at a later stage.

Note that if we are to encounter another repeat of late 2018 or early 2016, nothing is stopping us from shifting more funds out of equities and into cash, if that is our choice.

To all investors looking for that specific yield/income alternative: do your own research. All our choices are publicly listed vehicles. There are copious volumes available in info, data and research.

### Yield Is Never Risk-Free

Many investors are by now owning yield instruments varying from single company credit to bond ETFs and numerous alternatives in between, or they are now considering owning them. A few points of risk assessment you should consider:

-Corporate bonds are not without risk, especially not during times of economic stress. See also Pioneer Credit ((PNC)) listed on the ASX, or CF Asia Pacific Group (CFAP), not listed on the ASX but its debt might turn out worthless.

-A corporate bond with expiry date within the next two years or so will ignore the trends in cash rates and government bonds and trend towards nominal value. Payout on the date of expiration is 100% of the bond value.

However, given the global trend in recent years, this bond is likely to trade at a higher price, say 108 instead of 100. This means you are giving up more than the bond is yielding in capital erosion from here onwards. Something you should be aware of.

-Bond ETFs are useful, but they don't protect against capital losses in the same fashion as an individual bond with set expiration date does. If the trend in global yield reverses, or in case global government bonds experience a serious correction, your standard bond ETF will reset in line with lower bond prices, and you might not be able to make up for the commensurate loss in capital.

Also note: even though the Portfolio has never been fully invested, in the share market or elsewhere, this has not stopped the All-Weather Portfolio from outperforming the ASX200 Accumulation Index most of the times during its 4.5 years of existence.

Below is a repeat from last week's performance update:

### All-Weather Portfolio Performance

The FNArena/Vested Equities All-Weather Model Portfolio significantly outperformed the broader share market in August with several portfolio constituents posting sizable rallies upon releasing financial results. Only a small number genuinely disappointed.

Whereas the ASX200 Accumulation Index dived deep in the red, and recovered somewhat during the final days of the month, to post a -2.36% loss following a positive performance of 2.94% in July, the All-Weather Portfolio posted gains of 2.95% in July and 0.47% in August.

The combined performance for the All-Weather Portfolio over the first two months of the new financial year is thus 3.43% compared with 0.52% for the ASX200 Accumulation Index.

### Rudi Talks

Audio interview from last week

<https://www.youtube.com/watch?v=ca960WHUiOg>

### Rudi On Tour In 2019

-AIA and ASA, Perth, WA, October 1

In 2020:

-ASA Hunter Region, near Newcastle, May 25

(This story was written on Monday, 9th September 2019. It was published on the Tuesday in the form of an email to paying subscribers, and again on Thursday as a story on the website. Part Two this week will be written on 11 & 12 September and published on Friday).

(Do note that, in line with all my analyses, appearances and presentations, all of the above names and calculations are provided for educational purposes only. Investors should always consult with their licensed investment advisor first, before making any decisions. All views are mine and not by association FNArena's - see disclaimer on the website.

In addition, since FNArena runs a Model Portfolio based upon my research on All-Weather Performers it is more than likely that stocks mentioned are included in this Model Portfolio. For all questions about this: [info@fnarena.com](mailto:info@fnarena.com) or

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\*\*\*\*

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## Rudi's View: Rotation Anxiety & Conviction Buys

Dear time-poor reader: updates on stockbrokers' Conviction Calls plus extra updates post the August reporting season

In this week's Part Two of Weekly Insights:

-Conviction Calls -Post-August Afterthoughts -Rudi Talks -Rudi On Tour

Conviction Calls

Rudi Filapek-Vandyck, Editor FNArena

A correction in bonds globally is causing portfolio rotation in the share market this week, with some outsized impacts on share prices in popular midcap favourites including Pro Medicus, Appen and Charter Hall. It has to be noted though, share market strategists at UBS do not seem nervous about it.

Instead, they published a dissertation this week as to why ultra-low interest rates are here to stay, and with the RBA continuing to cut the cash rate locally, UBS is strongly suggesting investors should retain a close eye on stocks that benefit from lower long-term bond yields.

The strategy team has come up with the moniker "Defensive Income and Growth", shortcut "DIG". Key sentence in the report: "Although the DIG trade has run hard already, we think that, as analysts recalibrate their valuation models to use lower risk free rates, DIG stocks will benefit more than other stocks."

UBS has identified four groups of companies that stand to benefit the most from widespread acceptance the ultra-low bond yield environment is more permanent than previously thought.

First up are pure-play defensive income stocks such as GPT Group ((GPT)), Shopping Centres Australasia ((SCP)), Telstra ((TLS)), Transurban ((TCL)) and Woolworths ((WOW)).

Less yield-exposed income names that should also benefit include Aurizon Holdings ((AZJ)), Crown Resorts ((CWN)), Star Entertainment ((SGR)), Tabcorp ((TAH)) and Wesfarmers ((WES)).

Then there are the typical Growth stocks, of which UBS's most preferred names are Altium ((ALU)), Appen ((APX)), CSL ((CSL)), Goodman Group ((GMG)), REA Group ((REA)) and ResMed ((RMD)).

Last but not least are Growth companies trading at a reasonable price, including Aristocrat Leisure ((ALL)), James Hardie ((JHX)), Lendlease ((LLC)), News Corp ((NWS)) and QBE Insurance ((QBE)).

While bond yields globally are on the rise this week, UBS still sees Australian 10-year yields falling to 50bp by year-end.

\*\*\*\*

A special mention goes out to Morgan Stanley Chief Investment Officer Mike Wilson in the US who has kept to his forecast, originally made in 2018, that the S&P500 would remain capped inside a trading range with the ceiling at 3000 points and the bottom of the range some -10% lower.

The US share market index threatened to break-out to the upside in July, but ultimately didn't. It has remained near the top end of the identified trading range since. Wilson's belief is that the bottom of the range will be revisited in the next six weeks or so.

Further out, Morgan Stanley leans very much towards a likely recession for the US economy, with Fed rate cuts proving ineffective to stop the economy from sliding further downwards.

\*\*\*\*

Having said all of the above, Credit Suisse's market strategists have been making the point that investors might be too negative on the ultimate outcome of today's monetary policy actions taken by central bankers around the world. Monetary policy is still working, argue the strategists, it just requires time.

The problem with the above statement is that the world currently is convinced that monetary policy may no longer be working and this is why bond yields are as low as they are. Financial assets are priced for a global recession, argues Credit Suisse.

The key risk is then that if such a recession won't happen, the correction that needs to go through financial assets may not be nimble or gentle. For this reason, Credit Suisse strategists suggest investors start considering owning "value" in the share market.

Names suggested include Boral ((BLD)), Whitehaven Coal ((WHC)), BlueScope Steel ((BSL)), WorleyParsons ((WOR)), Vicinity Centres ((VCX)), Scentre Group ((SCG)), Bank of Queensland ((BOQ)), Origin Energy ((ORG)), Incitec Pivot ((IPL)), South32 ((S32)), Stockland ((SGP)), OZ Minerals ((OZL)), GPT Group ((GPT)), Nine Entertainment ((NEC)), Santos ((STO)), and Suncorp ((SUN)).

If one had to divide the share market into two broad groups of stocks, separating Winners from Losers, than the list of chosen names by Credit Suisse consists mainly of Losers, which is yet another way to warn investors the outlook for financial assets can include a trend reversal from the years past, if only temporarily.

\*\*\*\*

Stockbroker Morgans' monthly update on model portfolios has revealed some additional buying of shares in Cleanaway Waste Management ((CWY)), with Morgans convinced investors have responded too harshly to the disappointing result in August.

The portfolio managers placed Link Administration ((LNK)), Woodside Petroleum ((WPL)) and Credit Corp ((CCP)) on their watch list.

The Growth Model Portfolio is watching Bingo Industries ((BIN)), PWR Holdings ((PWH)), Opticomm ((OPC)) and Volpara Health Technologies ((VHT)).

\*\*\*\*

Sticking with stockbroker Morgans: the market strategists have now also updated their short list for Conviction Buys, comprising of ResMed, Sonic Healthcare ((SHL)), Cleanaway Waste Management, Woodside Petroleum, OZ Minerals, Westpac ((WBC)) and Oil Search ((OSH)) among large caps and Volpara Health Technologies and Senex Energy ((SXY)) among small caps.

For those who equally pay attention to the changes that have been made: Woodside Petroleum and Cleanaway Waste Management are new additions and Australian Finance Group ((AFG)) is the one that disappeared since the previous update due to share price strength.

\*\*\*\*

Bell Potter analysts Chris Savage and TS Lim have updated their favourites in the local tech sector. Bell Potter's Top Three Key Picks now consists of (in order of preference) TechnologyOne ((TNE)), Catapult Group ((CAT)) and Citadel Group ((CGL)).

WiseTech Global ((WTC)) remains the lone key Sell recommendation, based purely on valuation. Note that Bell Potter's valuation for the shares is no more than \$25.

The analysts do emphasise WiseTech is still regarded the best quality company in the sector, alongside Altium ((ALU)).

\*\*\*\*

Post reporting season, portfolio managers at Wilsons have added GUD Holdings ((GUD)) on the belief the share price had sunk too low. Wilsons remains a believer in the medium term outlook and sees this belief supported by signs of improving trading conditions, along with ongoing potential for bolt-on acquisitions.

Treasury Wine Estates ((TWE)) is no longer part of Wilsons Income Portfolio. Share price performance has been strong since inclusion, which has reduced the dividend on offer too much to remain included in this particular portfolio.

\*\*\*\*

The latest update on Wilsons' Conviction Calls also reveals GUD Holdings is now included, and that's the only change that occurred since the prior update before the August reporting season.

To refresh everyone's memory, the list of Conviction Calls contains 15 other inclusions: Bravura Solutions ((BVS)), EML Payments ((EML)), ReadyTech ((RDY)), Whispir ((WSP)), Collins Foods ((CKF)), Ridley Corp ((RIC)), ImpediMed ((IPD)), National Veterinary Care ((NVL)), Countplus ((CUP)), EQT Holdings ((EQT)), Pinnacle Investment ((PNI)), Noni B ((NBL)), Ausdrill ((ASL)), Mastermyne ((MYE)), and Whitehaven Coal.

### Post-August Afterthoughts

In a post-August review, analysts at UBS repeat yet again what a weak performance it was from corporate Australia and small caps contributed with full gusto to the generally dismal performance.

On UBS's calculations, the average small cap profit growth performance amounts to a negative -7% EPS growth in FY19. Clear message: the lack of profit growth momentum on the ASX is not purely a large cap phenomenon.

UBS equally repeats one of my own favourite statistical observations: in Australia, contrary to the USA, small caps do not generally outperform the large caps in terms of average investment returns. Having said so, on UBS's assessment, the relative discount for small caps versus large caps has widened in Australia to the largest gap since 2012.

On pure statistical impetus, this could mean it might be a good time to add more small caps exposure to investment portfolios. UBS modelling suggests a potential outperformance of 3% relative to large caps could be on offer.

UBS research suggests investors might consider adding Appen ((APX)), Imdex ((IMD)), Myer ((MYR)), Nanosonics ((NAN)) and NRW Holdings ((NWH)). Stocks to avoid include GUD Holdings, Japara Healthcare ((JHC)), Mayne Pharma ((MYX)) and Speedcast International ((SDA)).

\*\*\*\*

Michael Knox, at stockbroker Morgans, makes the following observation in his post-August review:

"It's interesting to note the recent fall in companies growing their dividends, while the number of companies cutting dividends has stepped up slightly. We think investors need to be conscious of this creeping trend of both EPS and dividend disappointment."

Could not agree more. As a matter of fact, I intend to spend more time on this observation myself. Consider this a promise for personal follow-up.

Post reporting season Best Buy Ideas as selected by Morgans among large cap stocks are Telstra ((TLS)), Wesfarmers ((WES)), Woodside Petroleum, Sydney Airport ((SYD)), Orora ((ORA)), Cleanaway Waste Management, ResMed, Sonic Healthcare, Treasury Wine Estates, Aristocrat Leisure and OZ Minerals.

Best Buy Ideas among small caps involve Afterpay Touch ((APT)), Lovisa Holdings ((LOV)), AP Eagers ((APE)), Over the Wire ((OTW)), Kina Securities ((KSL)), PWR Holdings, APN Convenience Retail REIT ((AQR)), Orocobre ((ORE)), Volpara Health Technologies, SomnoMed ((SOM)), Otto Energy ((OEL)), Cooper Energy ((COE)) and Sundance Energy ((SEA)).

\*\*\*\*

Over at Macquarie, analysts noted the August reporting was a tough one for contractors to the resources sector. Macquarie observed a plethora in "relatively vague outlook statements".

Upon further reflection, the analysts do believe the macro picture should remain positive for the sector, with both resources companies' capex plans and the level of infrastructure spending holding up.

Macquarie only covers a relatively small selection of listed contractors in Australia. Of those, its current sector favourite is Downer EDI ((DOW)), followed by WorleyParsons ((WOR)), Cimic ((CIM)), and then Monadelphous ((MND)).

\*\*\*\*

Small cap retail specialists at Citi reshuffled their sector preferences post-August and the result is that restructuring New Zealand born jewellery retailer Michael Hill ((MHJ)) is now the most preferred small cap retailer on the ASX. Citi clearly is banking on the fresh CEO getting the execution done well.

The former sector favourite, Lovisa Holdings makes a big fall down the sector rankings to now have become the sixth most favourite small cap retailer investment opportunity in Australia. Mind you, Citi still labels Lovisa the "best long-term growth story" in the local market, at least among small cap retailers.



Michael Hill beats (in order of updated sector rankings) Baby Bunting ((BBN)), Super Retail ((SUL)), Accent Group ((AX1)), Beacon Lighting ((BLX)), then comes Lovisa, followed by Premier Investments ((PMV)), Harvey Norman ((HVN)), City Chic Collective ((CCX)) and Myer, with Nick Scali ((NCK)) closing the list.

See also Part One from earlier this week:

<https://www.fnarena.com/index.php/2019/09/12/the-right-lessons-to-learn/>

Rudi Talks

Audio interview about the share market this week:

[https://www.youtube.com/watch?v=bdf\\_Ygh\\_nxc](https://www.youtube.com/watch?v=bdf_Ygh_nxc)

Video interview with Peter Switzer:

<https://www.youtube.com/watch?v=tu3tE08bL2c>

(I appear around minute 11 for circa 12 minutes)

Rudi On Tour In 2019

-AIA and ASA, Perth, WA, October 1

In 2020:

-ASA Hunter Region, near Newcastle, May 25

(This Part Two story was written on 11 & 12 September and published on the subsequent Friday).

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